COVE STREET CAPITAL

Volcker Does Not Rule

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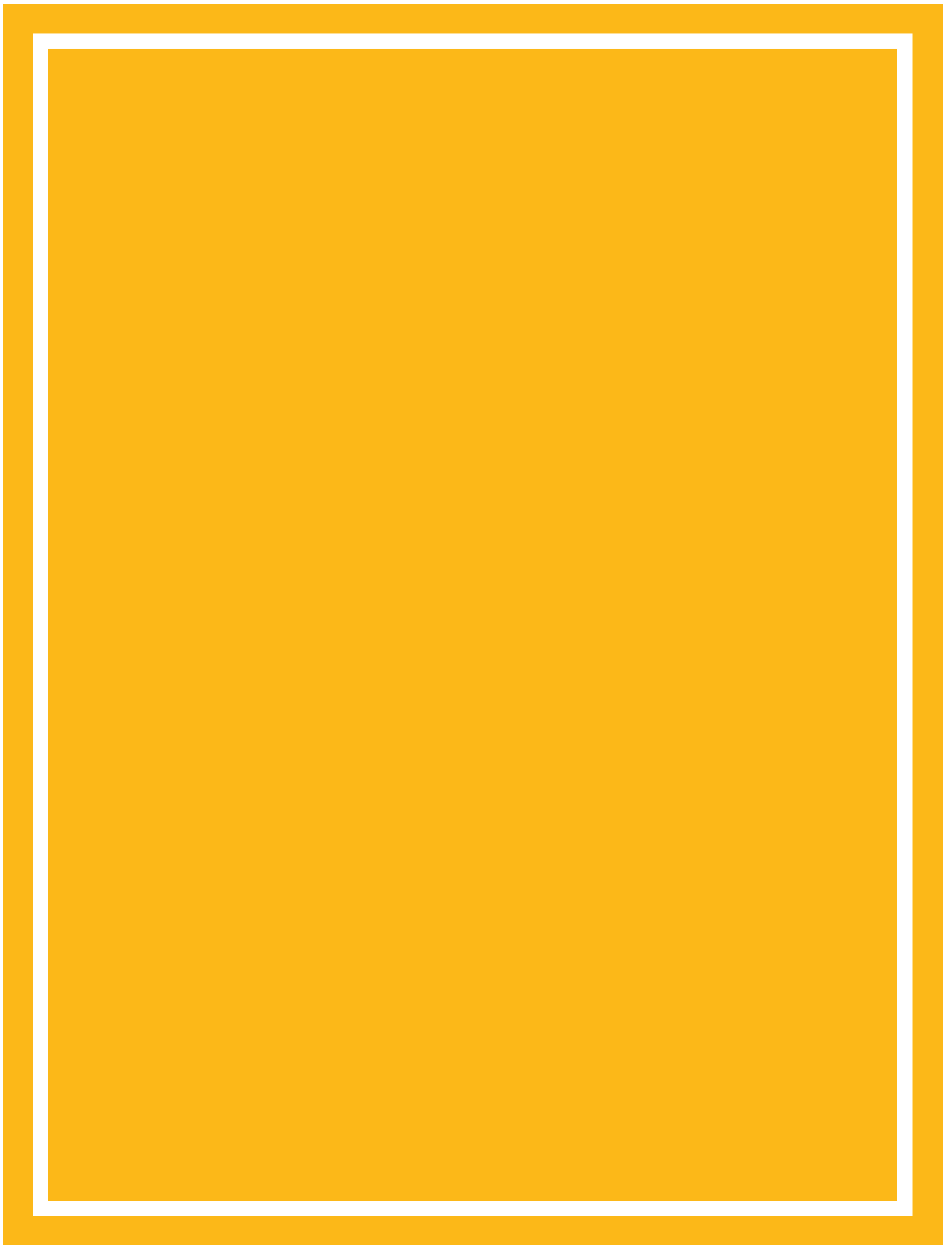

Volcker Does Not Rule

JUNE 2012 — There are many reasons an interested observer can conjure as to why the U.S. economy remains in a petulant quagmire, and some of them are actually not political in nature. Our mini-treatise today is on our particular favorite: the inanity of financial services regulation and the whipping boy of the month, Jamie Dimon of JP Morgan.

There are two punch lines. The first is that the ongoing train wreck that falls under the heading of re-regulating the global financial services industry is without a doubt a major cause of the slow economic growth in this country. Congress passed the Dodd-Frank Act in 2010 and a full one-third of the new regulations have yet to be published. The SEC, just one example of a federal agency charged with its implementation, has missed 65 percent of the 221 deadlines. Throw in the unelected officials scheming at the new Consumer Financial Protection Bureau (CFPB) who have yet to be fully heard from, the financial geniuses hiding out in Basel and the still to be determined by the Federal Reserve "Volcker Rule," and it should not be a terrible surprise that the world is awash with mere hesitation on good days and theatre burning panic on bad days.

The second punch line is that JP Morgan is a buy right here and right now. It is now one of our five largest positions in our All Cap strategy and for the record we have two other bank-like entities in the top five that are presently contributing very little to our performance: Bank of New York and Capital One. At $35, JPM trades at tangible book value and even in a worst case scenario of regulated mediocrity in which JPM earns a 10% long-term ROE, it would essentially be a financial utility that pays out a 5% yield with a stock price dragged north by 5% a year through growth in book value. I've had worse.

Break it up? That is a dumb idea in my opinion but go ahead, make my day. If you did a sum of the parts analysis and broke the Investment Bank into Goldman Sachs; Chase into Wells Fargo; Card Services into Capital One/American Express; Commercial Banking into M&T Bank; Treasury Services into State Street; and Asset Management into Blackrock, and simply used the currently (depressed) multiples of these comparisons, it is easy to pencil in something north of $50 per share. The "voting machine" is in full force right now with blathering from elected officials and the financial press in shrill Oprah mode, but it is the weighing machine that ultimately matters and you are being amply compensated for the novel idea that the next six months are uncertain.

I will neatly sum up the four main issues standing between the shareholders and "the bank" and focus on the two upon which definitive conclusions can be reached outside the Washington DC zip code. Let's all agree that a lousy U.S. economy helps no one, and poor loan demand is not an avenue for JPM or any bank to achieve a more normalized return on equity. Let us

also agree that the European Titanic is a very large known unknown and there are any number of banking contagion risks for JPM in the short run. That leaves L'Affaire d' Baleine, the satire passing for the financial reform, and the latter's longer-term effect on what will be the "normalized" return on JPM shareholder equity.

The former can be more easily addressed as it has less long-term impact on our investment. There is not an analog or digital filter that has been invented in the long history of film and photography that can soften the unpleasant image of a large trade gone bad, a rightfully proud CEO publically humiliated and the still to be determined pain of having to end the trade while the rest of the world's smartest men trade against you and extract daily pain. Need I mention a stock down $26 billion in value on a conceptual pretax loss estimated at "$2 to $5 billion?" I would have paid serious money to a charity of JPM's choice to have been in the room when Dimon realized that he had a Boston Tea Party on his hands rather than a "tempest in a teapot."

It is an absolutely true statement to suggest that JPM needs a serious relook of its internal risk controls, just as Johnson & Johnson is in need of a serious improvement of its manufacturing practices after a string of product recalls and I personally need to rethink how to handle the pair of teenage girls presently residing in my house who occasionally respond to the title of "daughter." But the most likely outcome in any of the above examples is that management stops, diagnoses the problems at hand, devises an implementable strategy for improvement and then executes. Statements babbled in the heat of the moment like "it's over" or "Jamie Dimon should resign in disgrace" have a miniscule attachment to common sense. (Thank you MIT Professor Simon Johnson—aka The Single Greatest Argument for Restricting Immigration.)

While I have personally sworn NOT to sprinkle Buffett-isms into any Cove Street communications in either written or verbal form until the November elections, our very own Ben Claremon was at the Berkshire meeting this year and we would like to enter this Buffett paraphrase into the record for some perspective:

> What seems possibly obvious is not that JPM is too big to fail but actually too big to trade and simply too big of a target. Every "hedge" represents a bet, and every hedge by definition involves "basis risk"—also known as the likelihood that your hedge simply stinks. The issue here is that JPM's overall exposure to nearly anything is likely too big to directly hedge and thus one assembles baskets of conceptually similar things that look and smell like they should move in the opposite direction. Clearly, rigorous oversight should have detected a problem with the position size relative to the market and that it didn't until it was too late was a JPM fault. The main reason this situation is anything like the public mess that it is, is that Dimon seemingly feels obligated to err on the "good citizen" side of the line, a decision that very deliberately cost shareholders an extra billion or two. (That and an SEC lawsuit.) That is a recognized risk and a multiple point penalty to owning JPM.

Which brings us to the real Kahuna and that is global financial services reform. The "hurt" here is that the Federal Reserve is presently holed up trying to put some regulatory meat on Congress' Dodd-Frank bones. In the midst of this, the shareholders of any large bank needed JPM to publically mangle itself like Roger Clemens needs a free medical marijuana prescription. There is not a single financial institution today that can answer the question: What do you think your return on equity should average over the next five years? Until the regulatory dust is settled—and as noted in the first paragraph, it is not even close—banks will under-earn and the economy will suffer.

To cut down on literary excess, I will note the following points:

1. You cannot regulate poor judgment. What you can do is create sufficiently high capital requirements, LOWER—not raise—Federal guarantees on deposit insurance and publically eliminate ANY sense of "Too Big to Fail." The "market" will be forced to think and will certainly get it more right than anyone in Washington or Basel.

2. Do you realize that the Federal Reserve had an office in Lehman Brothers for almost the entire year of 2008? That the members completely missed the build-up of risk in our financial system through 2007 and then bumbled their way through a resolution? That they regulate JPM and have hundreds of people parked in its offices and missed the whole "London Whale" issue? That they were also on top of MF Global? They are going to do better this time why?

3. You cannot distinguish "hedging" from "trading." Every transaction taken by a human has a bias, and how can you possibly maintain an institution that does not encourage every employee to have a bias toward making a profit? Can anyone tell if a hedge should be 89 futures contracts versus 100 contracts?

Only in Washington can someone like Barney Frank be allowed to say that "banks shouldn't be allowed to hedge against the economy or an entire portfolio, just a specific asset" without being laughed out the door.

4 In the three years ending 2011, JPM charged off $67 billion of good old fashioned loans. In every single case, a decision was made to loan someone money and that decision proved to be a poor one. Where is the outcry?

5 While I cannot in good conscience ask you to put down "Fifty Shades of Grey" and read "US Bank Regulation in Historical Perspective" by Professor Charles Calomiris, I will give you his three big conclusions about banking over the past few hundred years:

- Bank regulations have always been forged in the "crucible of crisis" and predictably do more harm than good.
- The overwhelming majority of banks have failed due to poor lending decisions, lack of geographical spread and lack of business diversification; in other words, too small and narrow to succeed.
- Government owned lending institutions have historically been egregiously poor financial institutions.

6 No matter how many times you say it, it doesn't become more true. Most U.S. banks did NOT want TARP money; it was crammed down their throats to avoid stigmatizing those that needed it. (Read any of the 47 books on the subject.)

7 The complete disaster in Europe is NOT the result of proprietary trading, derivatives or fraud. It is the same, good old-fashioned stupid lending decisions and poor sovereign spending policies that have plagued the communities of men since we slithered out of the primordial ooze. Volcker and his rules won't fix this.

8 Why are we going to punish the global banking system with Basel III regulations when the current mess is operating so well under Basel II? How many Roman numerals does it take to get it right?

9 Read the Letter to Shareholders in the latest JP Morgan annual report. It is neatly self-serving, but also a legitimate look at what banks are up against.

In closing, there is a self-evident problem associated with investing in banking stocks and it is a risk with which many are uncomfortable: regulatory risk. In general, you can have a pretty decent investment career by actively seeking to avoid regulatory risk. However, I would argue that this "self-evident" risk is by definition mostly priced into what you currently pay for a number of large cap banking stocks. The health of many of these institutions is impossibly intertwined with the general state of our economy. As such, if the status quo remains on an economic, political, and regulatory basis, then we are not likely to make a lot of money in banking stocks – or many other stocks for that matter. But we are presently paying very little for the possibility that maybe, just maybe, there will be a change at the margin and that the health of these institutions and overall economic growth will be weighed more heavily than a regulatory fiat to fight the last financial war and a politically motivated desire to apportion "blame" to anyone but the elected officials in Washington.

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Jeffrey Bronchick, CFA
Principal, Portfolio Manager

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