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Financials: Share Price Declines May Come to an End... But Years of Rebuilding Required Before Leadership Re-Emerges

*Banks have thus far recognized significant losses primarily from bad underwriting -- from making loans to people and companies that never had much chance of repaying them. We believe that banks will now enter the second phase of the Credit Crunch and be forced to recognize losses arising from a bad economy -- from loans that were originally good but that go bad because of the weak economic environment. **The level of losses incurred during this second phase will depend upon how weak the economy becomes, and will likely be well in excess of the losses recognized to date if our "Baseline" economic forecast proves correct.***

Michael Jones, *Strategic View -- Credit Crunch... It Isn't Over till it's Over*, 4/24/08
<http://www.riverfrontig.com/commentaries/pdfs/strategic/SV042108.pdf>

We anticipate another round of disappointments in the financial sector and that the bottom fishers that rescued their shares over the past three months will be less likely to "catch the falling knife" a second time.

Equity View -- What a Difference a Quarter Makes, Banks and Retailers Appear Vulnerable, 4/14/08
<http://www.riverfrontig.com/commentaries/pdfs/equity/ev041408.pdf>

At Riverfront, we have been negative on the financials for some time, and we have continued to believe that the dual bubbles in the real-estate market and credit market would take time to digest. After two back-to-back periods of nearly 20% drops (2007 and 2008), we are constantly fighting our valuation instincts to bottom-fish. While we recognize our vulnerability to a quick rally in the sector, we believe a "V bottom" is highly unlikely and that patience, not impulsiveness, will be the better strategy with regard to the financial sector. The reasons we believe the next bull market in financials is a long way off include the following:

- 1. Recession May Only Be In The Early Innings:** If a recession is upon us, it is too early to judge its depth and its implications. One thing we do know, however, is that current reserve levels at commercial banks are extremely low. Accounting rules prohibiting income smoothing and wide-scale write-offs and write-downs over the past 12 months have led to reserve levels much lower than in periods preceding prior recessions. In essence, this equates to a smaller "shock absorber" for the banks, which is illustrated in Chart 1 below. With reserves low, bank earnings and dividends will likely be increasingly funneled away from the shareholder.

Chart 1

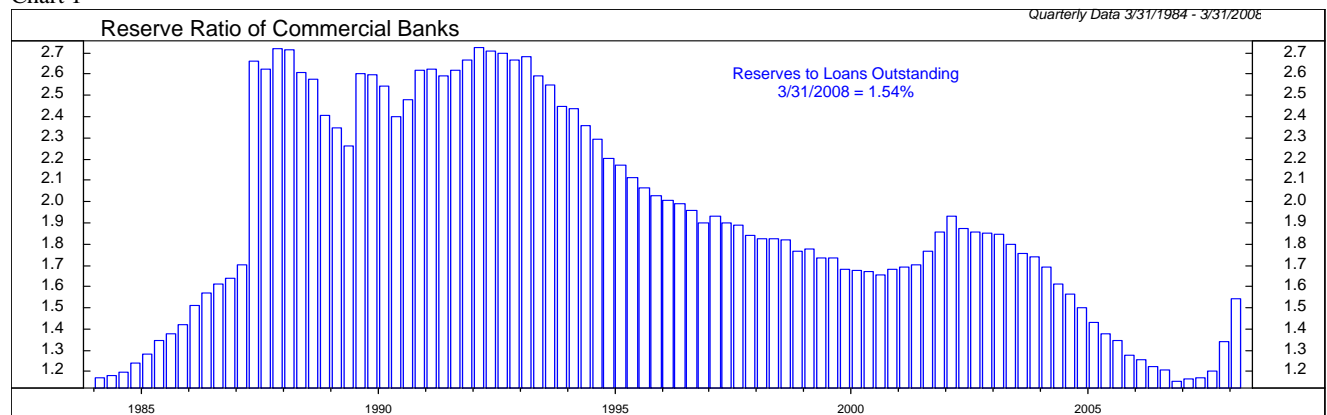


Chart Courtesy NDR Research

- 2. The Worse The Wounds, The Longer The Healing Period:** Few people quickly bounce back from a significant illness or injury. The worse the illness or injury, the longer the recovery and rehabilitation period. Companies and stocks are similar. A long period of share price decline can normally only be reversed after an equally long period of stagnation and rebuilding. Typically, management teams are reshuffled, top-line talent becomes more difficult to attract, and profitability levels drop as companies become less aggressive and less opportunistic. Additionally, there is the long-term obstacle of regaining the trust

and confidence of burned investors. In fact, an entire generation of investors may boycott the financial services industry for years to come, much like many abandoned the technology space after the '99 – '00 experience. Those that do not boycott the group are likely, in the very least, to be discouraged from paying a premium price for financial companies. Table 1 below displays the performance history of other sectors and groups that experienced similar bouts of significant underperformance and the length of time required before leadership was re-attained.

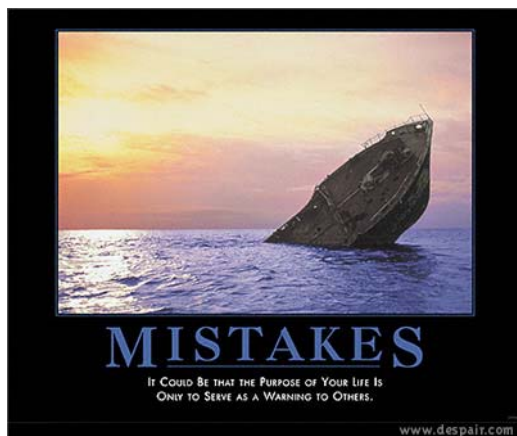
Table 1

Sector	Year Decline Began	Percentage Relative Decline	Years in Relative Decline	Years before Leadership Re-emerged
Financials	2007	22%	So far 1.5 years	?
Biotech	2000	80%	3 years	6 years and counting
Technology	2000	80-90%	3 years	6 years and counting
Pharmaceuticals	1991	38%	3 years	6 years
Gaming	1994	87%	5 years	2 years
Metals	1990	90%	11 years	2 years
Energy	1990	55%	11 years	4 years
Precious Metals	1988	91%	13 years	7 years
Department Store	1991	82%	9 years	2 years
Agriculture	1997	72%	3 years	3 years
Average		78%	6 years	4 years

Source: StockVal

Although financials have not fallen as long or as hard as some of their historical peers, it is important to remember that the sector was a lot less overvalued when its bear market started. The 70% and 80% drops in relative performance for technology and biotech followed bubble periods during which valuations were extraordinarily extended. While we are not ruling out the possibility of further damage, we think the most important conclusion from the table above is that *Rebuilding Takes Time*. Analyzing recent history, that average rebuilding period was four years, with no group re-establishing its leadership position in less than two years.

- 3. Catching A Falling Knife Is More Difficult With Three Fingers:** Investors who were motivated by the Fed’s aggressive rate cuts and who attempted to bottom-fish the financials in January-March 2008 have been badly burned. Not only do we expect these burned investors will *not* “doubled-down” after the latest drop, but their initial experience bottom-fishing will likely be a strong deterrent to others. With Fed rate cuts halted and the earnings of financial companies becoming increasingly questionable, even the deep-value investors are having a tough time determining what these businesses are worth.



Source: Despair.com

Those who bottom-fished the Financials too early have sent a very important message to the rest of us

- 4. Shareholders Playing Second Fiddle:** The balance sheets of many financial institutions, particularly the banks, are getting worse, and there are only two ways to improve them: (1) raise new capital or (2) preserve remaining capital. Since the crisis started, banks have primarily used dividend cuts, preferred stock issuance, or direct equity placements to preserve or raise capital. Today, the number of tools at their disposal is dwindling. Regulatory and rating agencies are beginning to limit the issuance of preferred stock, and the most obvious pools of capital for private placements (the sovereign wealth funds) have already been tapped. Therefore, we expect the pace of dividend cuts and equity issuance to increase. While both measures help insure the long-term viability of the entity (good for bondholders), the moves are extremely unfriendly to equity shareholders. Not only will dividend cuts and dilution scare away some of their remaining investors, these measures will likely make it difficult to attract new investors.

Bottom Line: On the surface, financial stocks are beginning to look oversold and are potentially due for a significant bounce. Those on the sidelines, like us, are feeling increasingly uncomfortable since such a bounce could be painful. However, we still believe it is too early to shift our bearish stance on the sector. The level of discomfort we have now, resulting from our fears of being stung by a bounce, is far less than the discomfort we would have felt if we bought in anticipation of a bounce that never happened. We simply do not have the conviction to hold financials should their underperformance continue. We would rather wait for greater clarity, even if it involves paying a slightly higher price.

While we see few long-term opportunities among the common equity of the financials, we are beginning to see some attractive opportunities in their Preferred Stocks. For more information on this topic, see *The Fixed Income View*, by Riverfront's Chief Fixed Income Strategist, Tim Anderson.

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