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## Financials...Now What?

We think the most difficult problem in investing is learning how to recover from a significant loss. Our instincts tell us to stay put and keep our heads down for fear of additional losses. However, in most instances this probably the worst advice one could follow. The best investors recover from their losses quickly by recognizing their mistakes, fixing them and moving on. Average investors recover from losses more slowly because they initially ignore mistakes and then hope for a miracle to bail them out. Lousy investors never recover from losses because they refuse to recognize they made a mistake and continue to add to their falling positions.

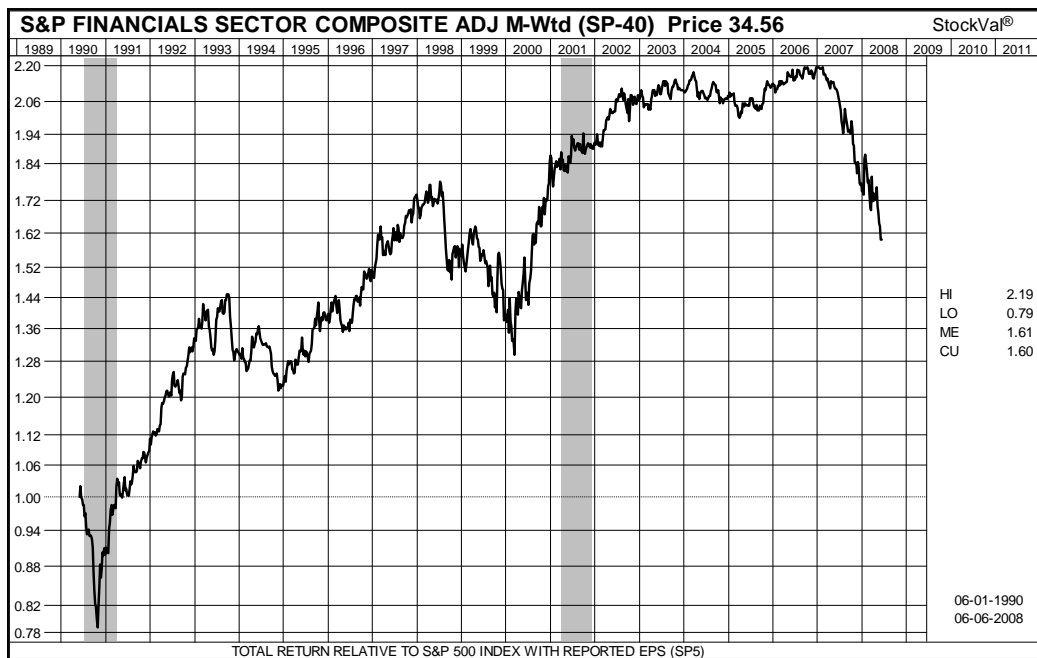
It is becoming increasingly clear that those investors who decided to bottom-fish the financial sector, or who ignored the market's clear and resounding message made a mistake. Financial stocks have yet to reach a bottom, in our opinion, and thus far there are few signs a bottom is on the near-term horizon. Fortunately, at Riverfront we are currently significantly underweight the financial sector, and have been so for more than a year. However, we recognize many do not share our underweight stance; and truthfully, after the last two weeks, no degree of underweight really feels like enough. Therefore, we wanted to dedicate today's *Trader's Note* to attempting to answer the question: "What should I do with my financials, now?"

**How to reduce financial exposure the "Smart way"** (Using the example of an investor with a 20% exposure to the financial sector):

1. **Determine the goal:** After the last two weeks of suffering, the urge to eliminate exposure to the financial sector through wholesale selling is high. While this may be an effective solution in the short run, we think this is a high risk strategy that would likely have long-term negative consequences. We believe the first thing an investor needs to do is to identify and quantify existing exposure, and then determine what their positioning would be if they built their portfolio from scratch today. Our investor with a 20% exposure to the financial sector is overweight the large-cap benchmark (S&P 500) by roughly 500 basis points ("bps" = 1/100<sup>th</sup> of 1%), and overweight our tactical recommendation (about 12%) by 800 bps. Therefore, *the goal would be to reduce financial exposure by 500-800bps.*
2. **Don't wait for a better opportunity; but lean, not leap:** The right strategy for achieving this goal, in our opinion, is to break it into at least three steps.
  - a. Step 1: Execute one-third of the desired trade now by selling 150-250 bps of exposure. The investment graveyard is full of well-intentioned investors who knew what they had to do, but hoped for a more palatable exit point that never came. Sure, executing a portion of one's strategy now, after the significant sell-off we've experienced, runs the risk of getting out too late; however, the strategy will only become more difficult to execute if this isn't the bottom.
  - b. Step 2: Execute the next one-third of the trade on a bounce. The financial sector is oversold today, and the likelihood of a "dead-cat" bounce is significant, in our view. If financials remain in a bear market, as we expect, then any bounce is likely to be an opportunity to sell, and will be limited to a retracement of no more than one-third of its recent sell-off. It's important, if a bounce comes, not to be too greedy waiting for a complete recovery and not to scrap your plan just because the pressure may have temporarily been alleviated.
  - c. Step 3: Execute the final one-third of the trade three to six months from today, or if the sector falls to new relative lows from current levels. Waiting to execute the final phase of the plan allows the investor to "average out" of their position, hopefully at prices more favorable than current levels. On the other hand, a break below today's relative lows would be further confirmation that a bottom remains a long way off.
3. **Prioritize your sales:** There are segments of the financial market that have been punished less severely and thus, in our opinion, have more downside if a bear market in the sector persists. Thus far, the majority of damage in the sector has been restricted to those entities that employed the most aggressive lending practices over the past few years. Financial companies with high subprime or Alt-A exposure have been "taken out and shot," while traditional lenders have been insulated. We believe that, as the economy enters recession, loan losses will be more widespread, investors will be less discriminating and even the best financial companies will be unable to "outswim the receding tide." Therefore, we recommend investors prioritize their sales strategy to sell those financials that have held up the best first. This would include many regional banks, real estate investment trusts (REITs) and selected segments of the specialty finance industry.

- Reinvest the proceeds:** Selling financial stocks today and leaving the proceeds in cash is the surest way to lock in a loss, in our opinion. Cash does not appreciate, and thus does not afford the investor a chance to recover. Therefore, it's important to redeploy the proceeds of the sale into sectors and stocks that have a better chance of appreciating. Potential areas for re-investment include the preferred stocks of financial companies, many of which pay attractive 8+% dividends and have a more senior claim on the assets of the company relative to common equity. We also currently recommend overweighting the Information Technology, Consumer Staples and Energy sectors of the market.

**Bottom Line:** Financials have yet to reach a bottom, and we are fearful it could get worse before it gets better. Going forward, we expect earnings to remain under pressure as the implications of a recession force many lenders to accelerate loan-loss provisioning, cut their dividends and bolster their capital structure through additional equity issuance. Given this environment, we do not expect financials to bounce back anytime soon and recognize that the group may languish for multiple years. It is important to understand that underperformance typically comes in two flavors -- Absolute and Relative. It is our belief that the majority of absolute underperformance (falling share prices) has already been realized. However, we think the greater risk to investors going forward is relative underperformance (opportunity cost). The financials, in our opinion, could perform similarly to other big sectors and industries, such as the drugs or technology stocks, that have historically leaked performance for many years after the initial damage has been done.



S&P Financials outperformed the broad market by more than 100% from 1990 to 2006. This degree of outperformance significantly eclipsed any of the other nine sectors in the S&P 500.

Since 2006 the group has retraced half of its gain, yet still remains among the top-three performing sectors on a total-return basis since 1990.

Chart Courtesy StockVal

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