Q4 2011

Fellow Investors,

It was a tough year.

Our portfolio lost value this year and as my own largest client, my wallet is a little lighter this year than last. That doesn't bother me so much, but I did feel frustrated losing value for the friends and family that are investing with me.

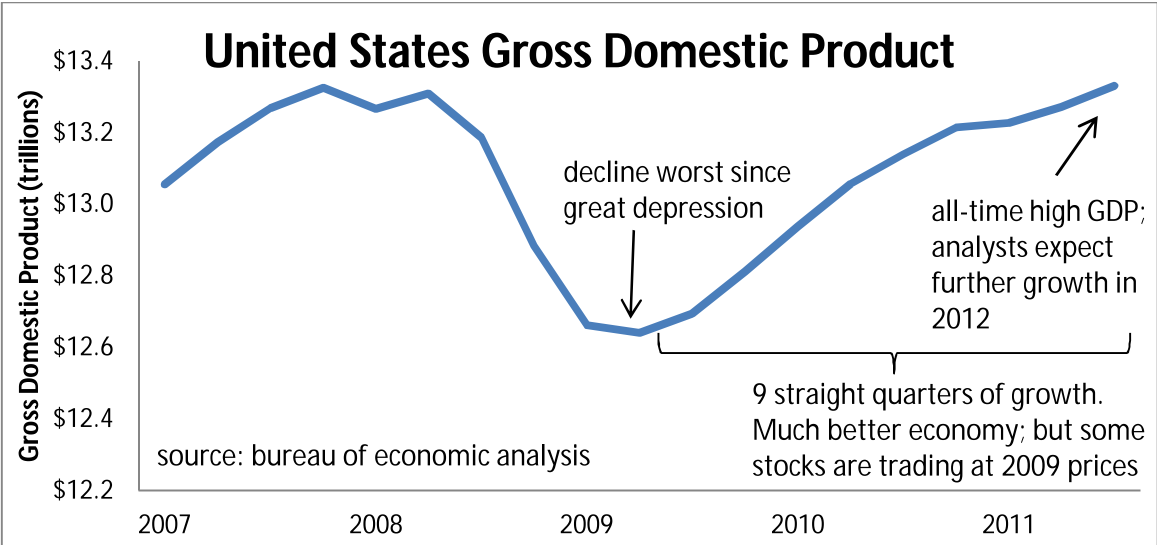
In the past, I've done comparatively well during market crashes – such as the internet and housing crash – because I'm attuned to the bubbles that precede such crashes. While I was aware of the problems brewing in Europe this year, I underestimated their influence on our portfolio.

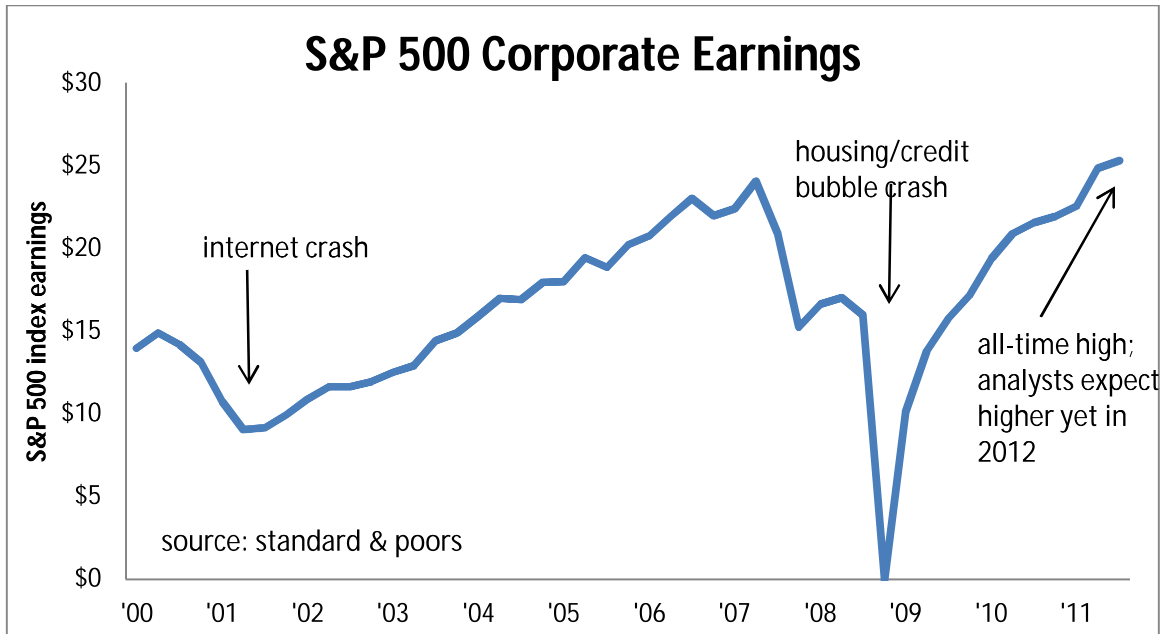
Indeed, this year's buys are primarily stocks I felt were excessively tarred by the European crisis; my major mistake this year was buying those stocks too early, as they kept on falling.

In this letter, I want to share my view that Europe has less of an influence on the U.S. economy and U.S. corporations than the market seems to believe. Then I'll discuss large U.S. banks, which seem exceptionally cheap right now.

The European crisis created U.S. stock-buying opportunities.

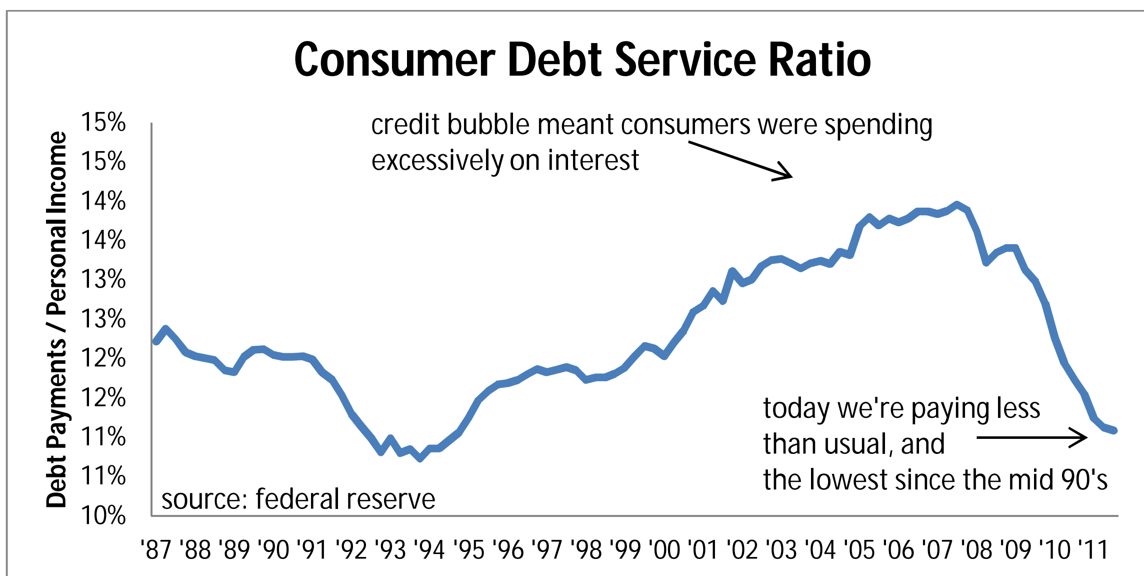
The stocks we own today generally trade at prices last seen during our own financial crisis. This is puzzling, since the U.S. economy and its corporations are doing far better today. Not just better: United States GDP and corporate profits currently stand at all-time highs.





I believe Europe has a smaller impact on the U.S. economy than the stock market's wild ride tells us. It's hard to imagine more than a few people basing their purchases of homes, cars, or presents on Italian bond yields (even super-vigilant financial types like myself). Only the people and companies that export to Europe – a relatively small portion of our economy – will be directly impacted.

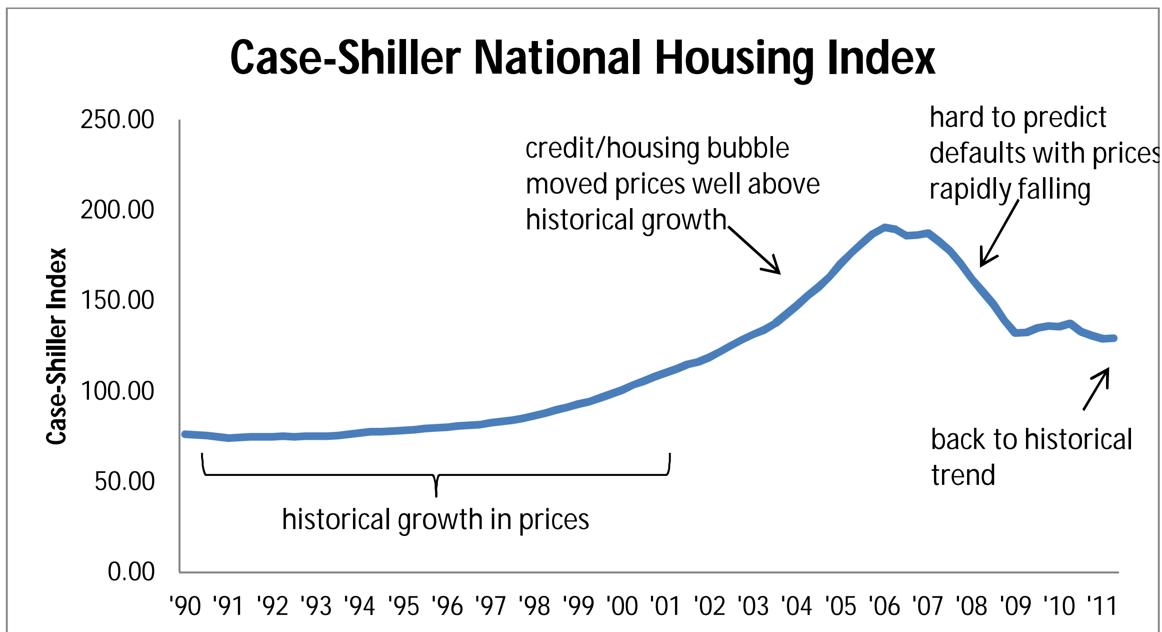
The crisis in Europe is helping the U.S. economy in many tangible ways. As European interest rates have gone up, bond-buyers have fled to the safety of U.S. government bonds, causing its interest rates to decrease. The low cost of borrowing has flowed down to some companies and individuals. Our government can borrow at 2% interest rates for 10 years (i.e. likely lower than long-term GDP growth), and highly credit worthy individuals can get 4% mortgages. As a result, U.S. consumers are spending less on debt than they have in the past 15 years.



In 2005, the graph that most convinced me there would be a housing crash was housing price indexes, which showed that housing prices were growing far faster than the historical trend. That led me to steer clear of (and even profit from) the eventual housing crash. I've copied that graph below, updated to the present.

Housing prices may bottom in the next two years. The crash has brought prices back in line with historical prices; affordability indexes and mortgage rates suggest it's a good time to buy, and household growth is much greater than the number of homes being built.

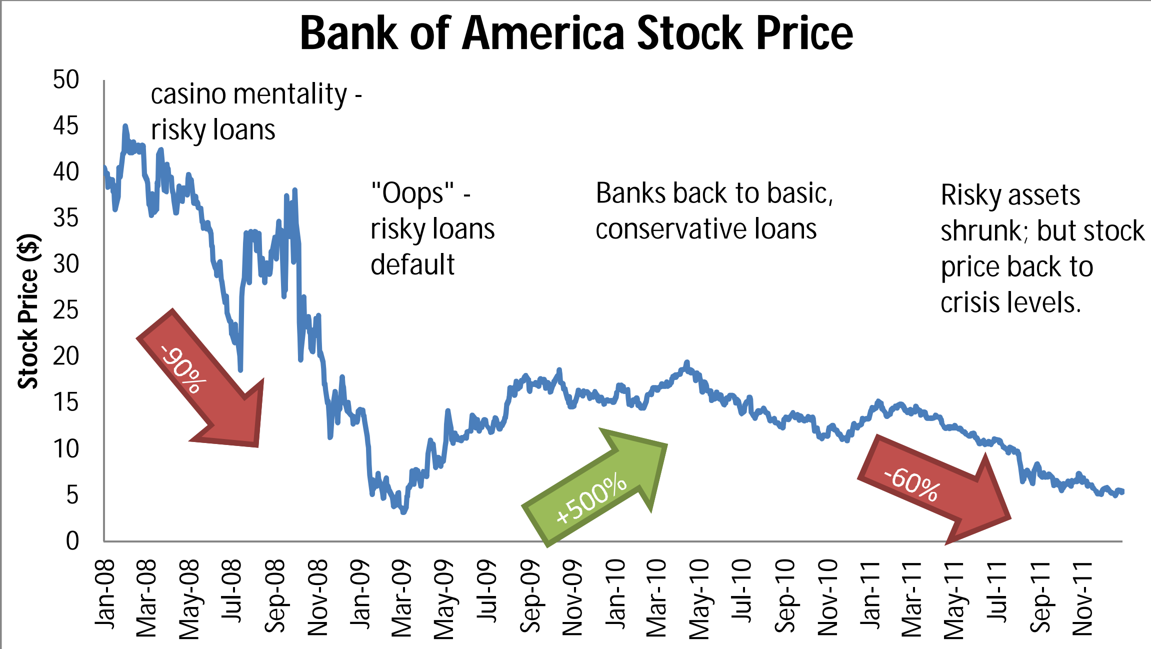
The fall in home prices has been a real headwind to our economy since 2007, and when home prices start slowly rising again, that will help our economy grow. In particular, it will help some of the hardest hit sectors of our economy – construction and manufacturing – which in turn will help drive our (still high) unemployment rate down.



The U.S. economy is on much firmer footing than during the 2008-2009 financial crises; yet many of our stock holdings are trading at prices similar to their financial crisis prices. I think this is an over-reaction to the European debt crisis.

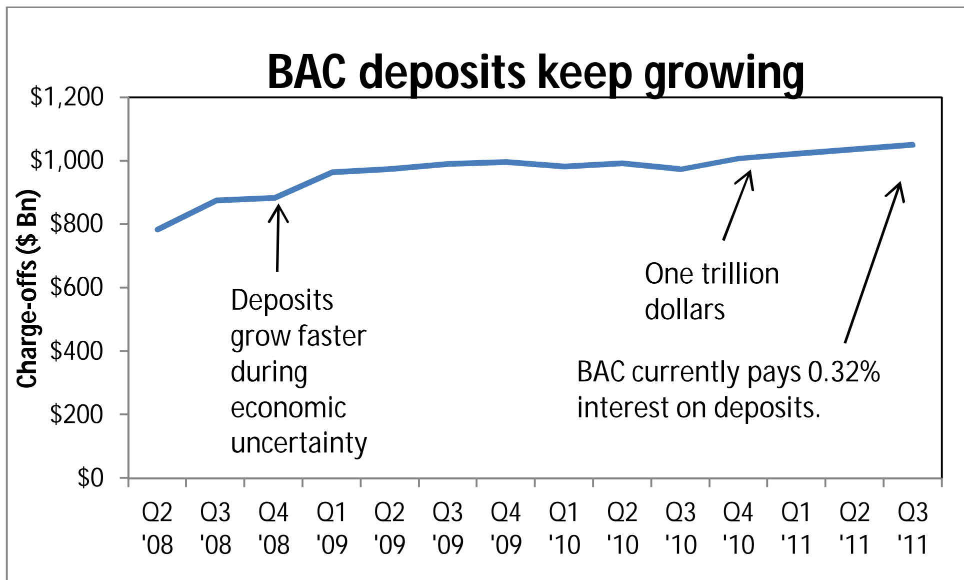
Opportunity lies in large U.S. banks.

Sometimes I wonder if Bank of America decided to become the ‘Bank of Greece’ and I somehow missed the news. This year, Bank of America stock declined more than stocks of some of the European banks that were central to the financial crisis.



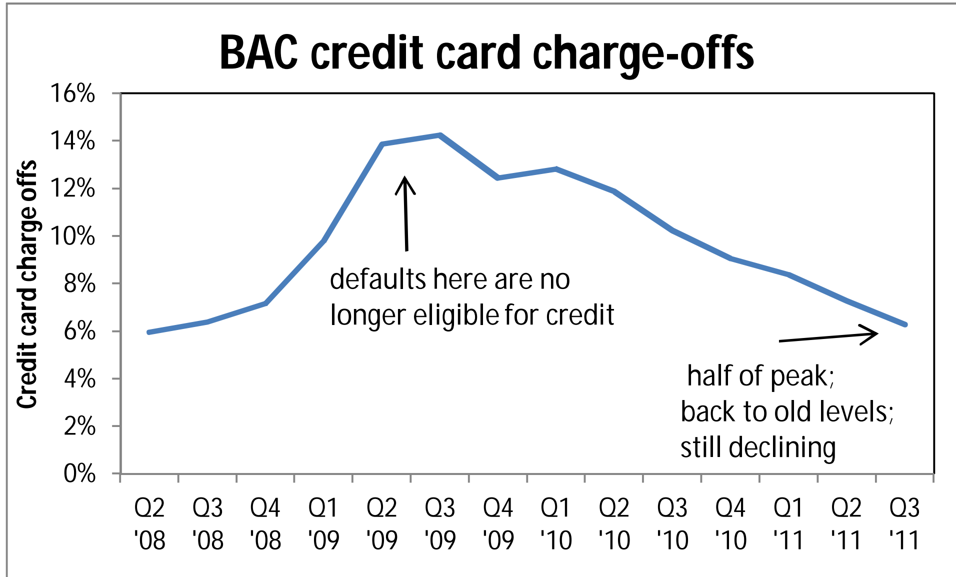
In contrast to U.S. banks’ share prices, U.S. banks currently have the highest capital ratios in their history. Capital ratios are a complex metric that regulators use to measure a bank’s ability to withstand unforeseen credit losses and macroeconomic shocks. Ever since the financial crisis, regulators have been pushing for still higher capital ratios, particularly for the large banks. They’ve set a final “due date” of 2019, and I believe all indications suggest that the large banks will achieve their required levels many years in advance.

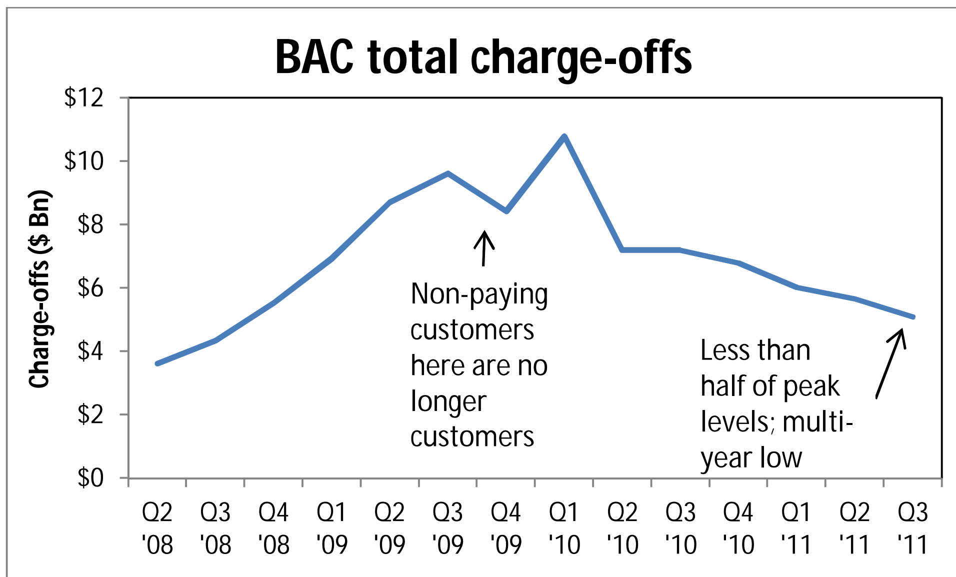
Deposits are also at an all-time high and keep increasing. Deposit levels in U.S. banks are actually growing as European corporations, banks, and individuals want to do business with safe U.S. banks instead of riskier European banks!



Credit risk has been declining in the years since the financial crisis. During the crisis, home prices plummeted, unemployment jumped, and corporations failed. So, all sorts of loans went into default – mortgages, credit cards, business loans, and so on. Those loans, for the most part, have been written off already (the defaults mostly happened in 2008 and 2009). The loans that kept paying through the crisis are likely good risks – if they didn't default then, it's doubtful they will default now, and certainly not at the rates seen in 2008 and 2009. Furthermore, the new loans that have been underwritten recently are generally high quality, demanding larger down payments and more documentation.

The two graphs below represent charge-offs for Bank of America, first for credit-cards and second for the entire loan portfolio. A charge-off occurs when a loan is considered to be a bad loan, which happens when a customer stops paying interest for a certain period of time.

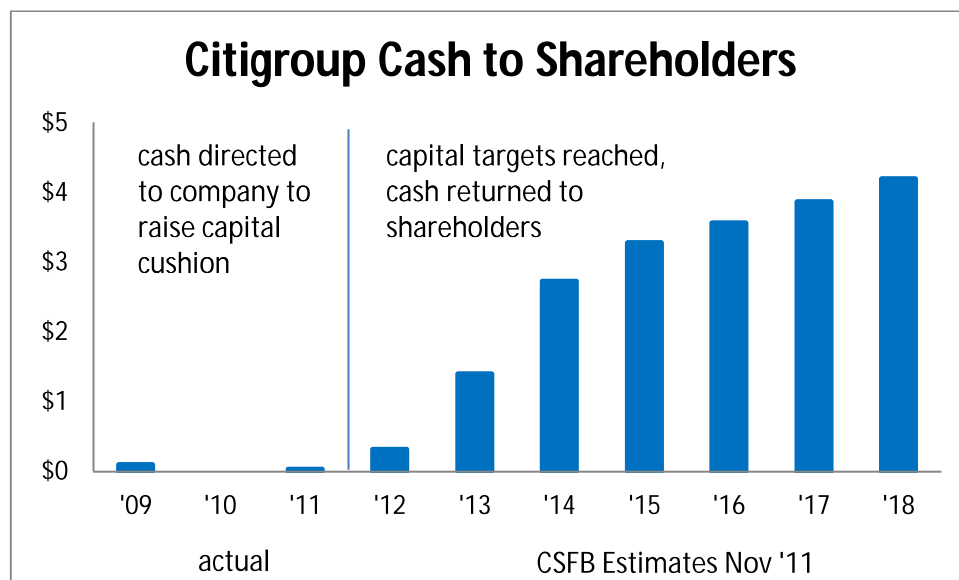




Investors are fleeing … right as banks are exiting the penalty box.

During the credit crisis, U.S. banks were put into a “penalty box” where banks suspended dividends to shareholders. That cash, instead, went to growing capital cushions to pay for losses being charged and to guard against future losses. Today, after three years of halted dividends, capital ratios are at high levels, and banks are in the process of resuming their cash payments to shareholders in the form of dividends and repurchases. It’s a little puzzling to watch shareholders wait for years to be rewarded by companies, only to sell them right before the dividends increase.

Below I’ve graphed the historical payout for Citigroup (another one of our holdings) and estimates for future payouts created by Credit Suisse First Boston.



The banks have spent the last three years rebuilding their companies from the credit collapse. They’ve built their capital cushions, reduced risky lending, and written off the poor loans of the past. Today we are investing in safer, more conservative banks than in the past – banks that are about to resume sending cash back to shareholders. The amounts of cash that I think the banks will return is very high in relation to their current stock price, which I think will eventually push the price of bank stocks higher.

Conclusions

While I did find 2011 a challenging year, my belief in the Buffett-style of investing has not changed. My perspective is that the market has become overly sensitive to the European crisis while largely ignoring the good news in our economy and corporations. I’ve made profits off of many downturns by being persistent and patient with my views, and I believe over time we’ll be rewarded again.

Kai Shih Q4 2011