The Financial Sector

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Introduction- Financial Sector

- The financial sector consists of investment banking firms as well as large commercial banks.

- The ticker symbol is XLF

- Top 5 companies in the sector as a % of index weight are 1. Wells Fargo, 2. JPMorgan Chase 3. Berkshire Hathaway 4. Bank of America 5. Citigroup Inc.

- Total of 81 companies represented in the sector

Introduction - Continued

- The leading industries within the sector are Insurance, Commercial Banks, and Diversified Financial Services

- The current average price per share in the sector is $15.16

- Last time it was the highest weighted sector was in 2005 with a weight of 21.2 this coincided with the economic boom from 2005 to late 2007.

Financial Sector Overview:

Financial Sector:	Total Market Cap (Billions):		Return on Equity TTM:	P/E TTM:
Captial Markets	$	579.30	8.83%	19.62
Commerical Banks	$	2,100.00	10.12%	11.02
Consumer Finance	$	139.40	21.54%	11.68
Diversified Financial Services	$	476.60	-20.74%	10.89
Insurance	$	934.00	9.37%	11.87
Real Estate Investment Trusts	$	645.40	6.72%	87.76
Real Estate Management & Development	$	101.20	9.63%	34.9
Thrifts & Mortgage Finance	$	56.90	5.16%	25.9
Totals/Average	**$**	**5,032.80**	**6.33%**	**26.705**

Total Market Valuation = $5.03 Trillion

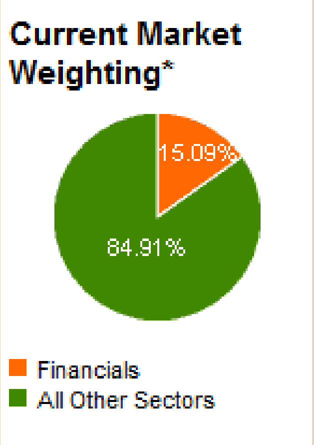
Recent Performance:

Benchmark: S&P 500 | Display Graph For: 1 Year | Update | END OF DAY DATA AS OF 4:00 PM 09/18/12

Click an Industry for an Overview.

AVERAGE PRICE CHANGE (%)

Industries	1 Day	1 Week	1 Month	3 Months	YTD	1 Year
S&P 500	-0.13%	1.80%	2.90%	8.52%	16.04%	20.01%
Financials	-0.45%	2.34%	5.94%	12.09%	22.98%	23.84%
Capital Markets	-0.47%	2.63%	8.30%	15.44%	20.67%	15.69%
Commercial Banks	-0.03%	2.61%	4.81%	10.80%	25.46%	38.74%
Consumer Finance	-0.95%	2.03%	2.05%	7.88%	30.94%	23.24%
Diversified Financial Services	-0.27%	3.32%	12.76%	18.27%	31.48%	20.33%
Insurance	-0.35%	1.80%	3.50%	9.99%	15.70%	22.61%
Real Estate Investment Trusts (REITs)	-1.03%	0.59%	2.02%	6.12%	16.52%	18.60%
Real Estate Management & Development	-1.70%	7.53%	8.73%	16.74%	27.51%	29.89%
Thrifts & Mortgage Finance	-0.21%	1.34%	5.15%	11.78%	11.12%	8.72%



The financial sector has outperformed the S&P 500 over the past year by 3.83%

Top 20 Largest Equities of Financial Sector:

Company Name	Symbol	Security Type	Sector	Market Capitalization
WELLS FARGO & CO	WFC	Common Stock	Financials	$187.2B
HSBC HOLDINGS PLC	HBC	Depository Receipt	Financials	$172.4B
JPMORGAN CHASE & CO	JPM	Common Stock	Financials	$156.7B
BERKSHIRE HATHAWAY INC.	BRK/A	Common Stock	Financials	$123.3B
CITIGROUP INC	C	Common Stock	Financials	$99.5B
BANK OF AMERICA CORP	BAC	Common Stock	Financials	$99.5B
BERKSHIRE HATHAWAY INC.	BRK/B	Common Stock	Financials	$96.3B
ROYAL BANK OF CANADA	RY	Common Stock	Financials	$83.6B
BANCO SANTANDER SA	SAN	Depository Receipt	Financials	$77.5B
WESTPAC BANKING CORP	WBK	Depository Receipt	Financials	$77.3B
TORONTO-DOMINION BANK (THE)	TD	Common Stock	Financials	$76.5B
MITSUBISHI UFJ FINANCIAL GROUP	MTU	Depository Receipt	Financials	$69.9B
AUSTRALIA & NEW ZEALAND BANKING GROUP LTD	ANZBY	Depository Receipt	Financials	$67.6B
AMERICAN EXPRESS CO	AXP	Common Stock	Financials	$66.5B
U.S. BANCORP	USB	Common Stock	Financials	$64.8B
BANK OF NOVA SCOTIA (THE)	BNS	Common Stock	Financials	$64.7B
BNP PARIBAS	BNPQY	Depository Receipt	Financials	$63.6B
NATIONAL AUSTRALIA BANK LTD	NABZY	Depository Receipt	Financials	$58.2B
GOLDMAN SACHS GROUP INC (THE)	GS	Common Stock	Financials	$57.5B
ALLIANZ SE	AZSEY	Depository Receipt	Financials	$55.7B

Ranked by market capitalization as of September 19, 2012

Recent Sector Commentary:

"S&P recommends marketweighting the S&P 500 Financials sector. Year to date through August 24, the S&P Financials Index, which represented 14.4% of the S&P 500 Index, rose 16.1%, versus a 12.2% gain for the S&P 500 Index. In 2011, this sector index fell 18.4%, versus a flat showing for the 500. There are 20 sub-industry indices in the sector, with Other Diversified Financial Services being the largest at 17.3% of the sector's market value." – **Standard & Poor's Sector Commentary (September 16, 2012)**

Examples of diversified financials include: JPMorgan, Bank of America, Citigroup etc.

Sensitivity to macroeconomic shifts

-Financial Sector is historically extremely sensitive to changes in macroeconomic factors

- Interest rate sensitive
- Inflation sensitive
- Other factors

Historic Sensitivity

- Have been the most sensitive sector historically
  - In 1970's financial sector performed the very poorly during periods of high inflation

Volatility compared to S&P 500

-Sensitivity to interest rates, inflation and other macroeconomic events make the financial sector a historically volatile stock compared to the market as a whole

-From September 4th to September 19th S&P gained 3% while XLF gained 5.5%

Historical Outlook: 1998 - Present

In comparison with S&P 500

Financial Sector and the Business Cycle

Cyclical Sector

-Stock Beta's > 1

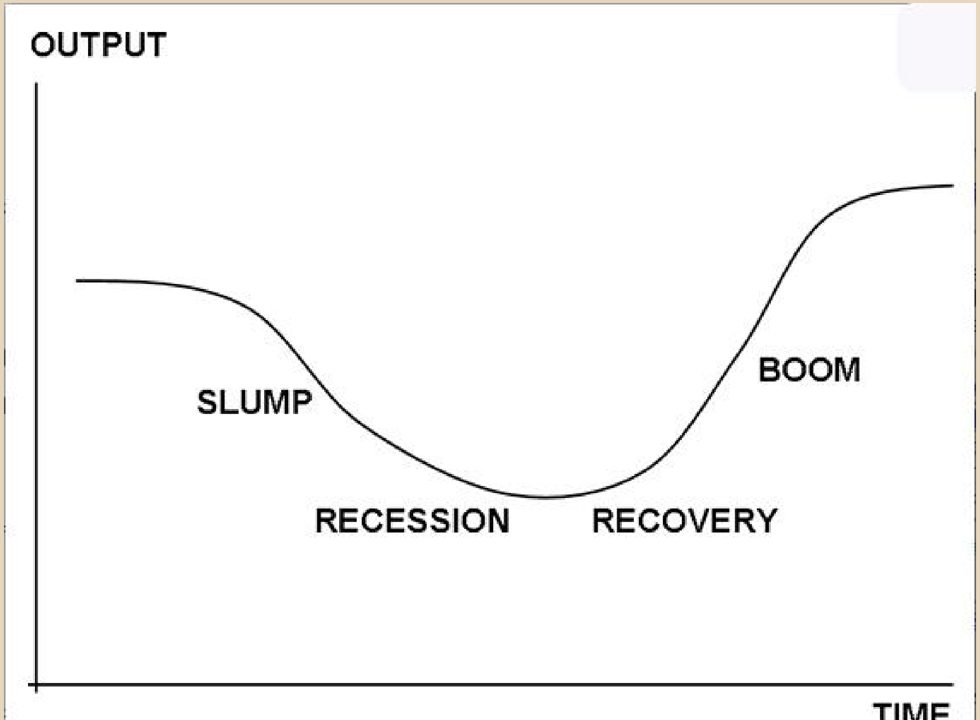
-Prosperous in expanding economy

Banks

Financials

Isurance

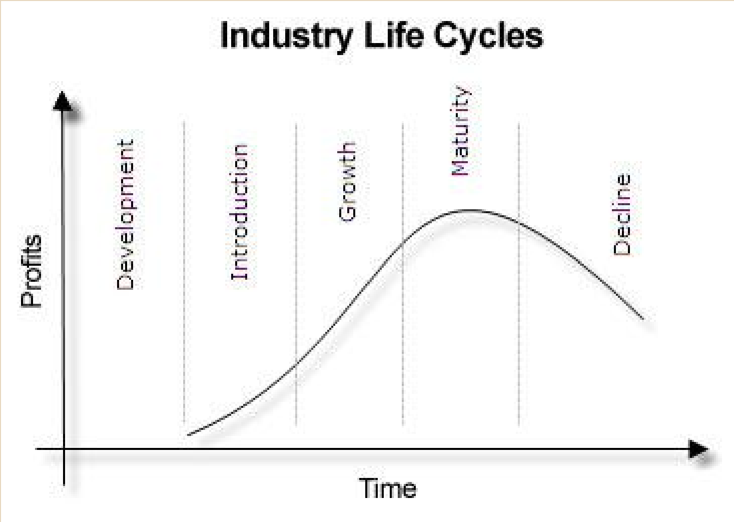
Real Estate



Financial Product Lifecycle

- Financial Products Have Life-Cycles too

- Where is the Financial Sector as a whole?



Financial Crisis

-Subprime mortgage crisis

-Defaulted loans

-Credit Default Swaps ($62 trillion market)

-Hit the banking industry hard

-Financial sector bailouts

(insuranceproviders.com)

AIG's risk exposure from credit default swaps on Feb. 28, 2008.

-would wind up defaulting on $14 billion worth of credit defaul swaps

Financial Crisis

-AIG: $85 billion bailout from the U.S. Federal government

-Lehman Brothers collapse

-Feb. 2007: Stock traded at $86.18

-Market Cap: $60 Billion

-4th largest investment bank

-Sept. 15, 2008: Declares bankruptcy

Financial Crisis

-Sep. 21, 2007; S&P 500: 1525.75, FIN: 464.45

-Mar. 6, 2009; S&P 500: 683.38, FIN: 81.74.

-Lowest point for S&P 500 and FIN index

-S&P 500: decreased 55%

-FIN: decreased 82.4% (27.4% difference)

Recent Macroeconomics Variables:

- Unexpected slowdown in loan growth has well positioned U.S. banks to perform steadily through year end.

- Recovery of bond and equity markets pushed 2012 Q1 results slightly higher than originally anticipated.

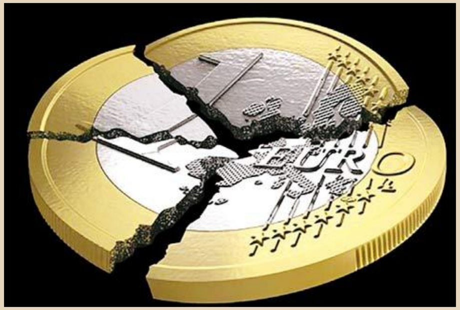
- Revenue growth fell slightly short of expectations in Q2, which was blamed on a decelerating economy.

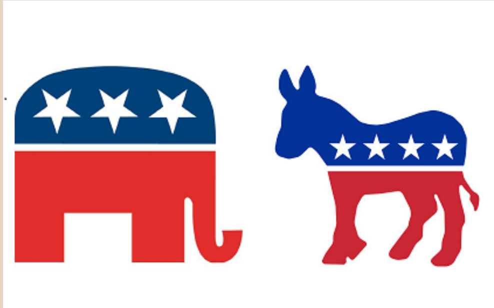
Recent Macroeconomic Variables:

Short-term factors affecting uncertainty:

- Frugal federal spending

- On-going European crisis
- Tax law uncertainty (U.S. election year)





Impact of the federal government:

- Increased federal spending may stimulate growth in the financial sector.

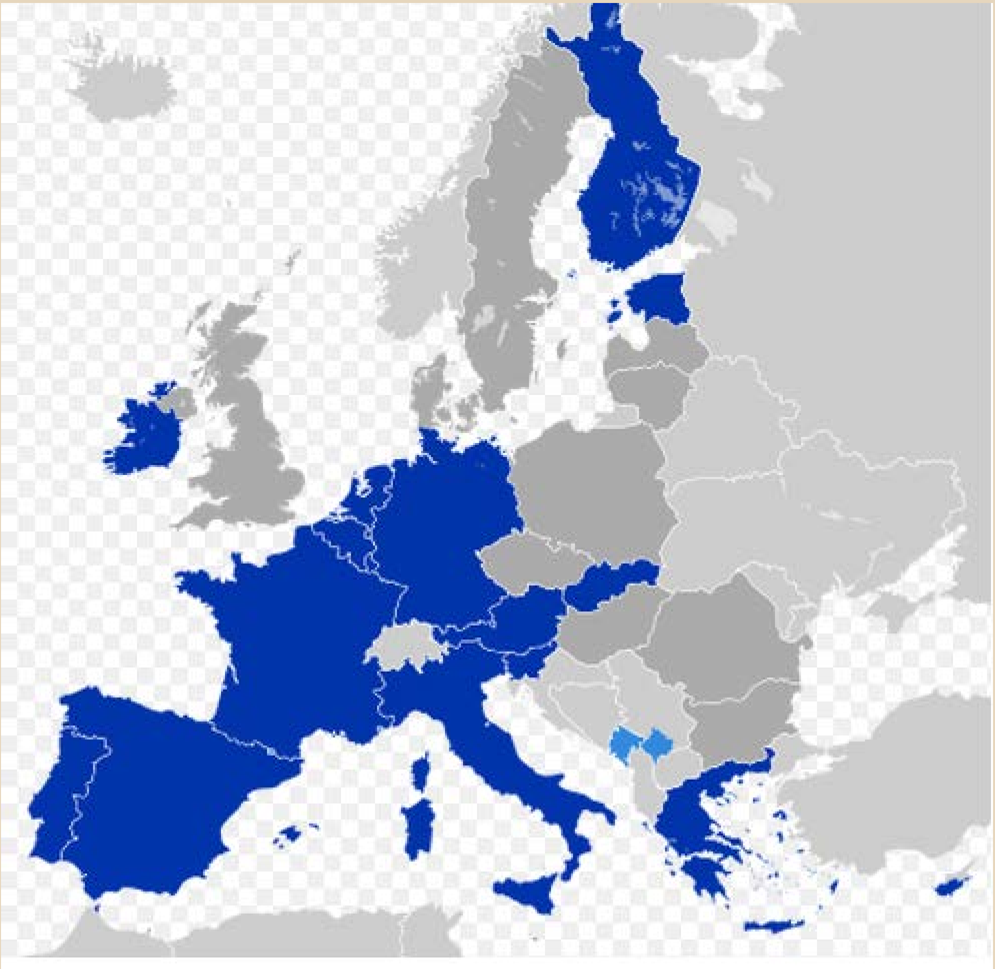
- At times, the federal government may use taxpayer money to anchor big banks.
  - Ex. Troubled Asset Relief Program (TARP) in October of 2008.
  - Authorization to spend over $450 billion of taxpayer money.

Current european economic crisis:

- Financial crisis resulting from many eurozone countries being unable to refinance their debt.

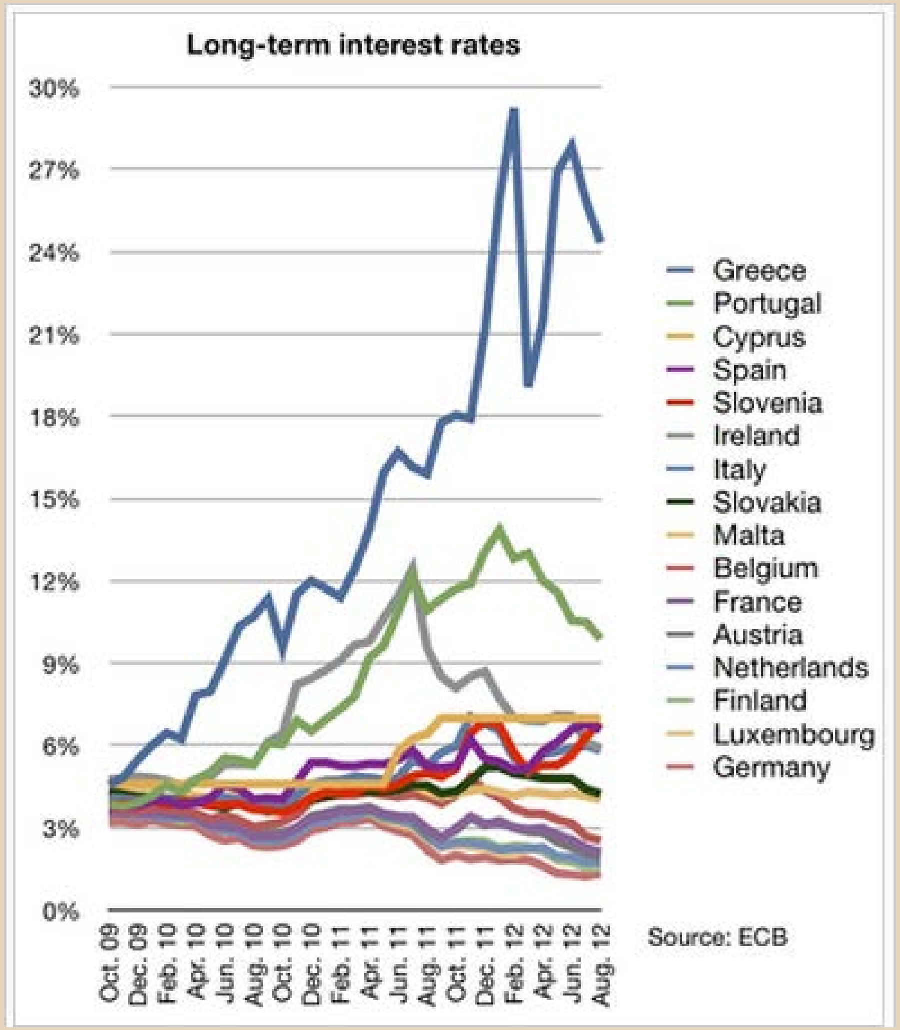
- Some of the most financial unstable european countries include: Greece, Portugal, Cyprus, Spain, Slovenia, Ireland and Italy

Countries using Euro currency:



- Europe contains four of the top ten largest economies ranked by nominal Gross Domestic Product (GDP).

European Interest Rates:



- Low credit ratings create high interest rates.
- Higher interest rates make it difficult for unstable countries to refinance their debt.

Meeting financial obligations:

- Some countries are able to create more of their own currency in order to meet financial obligations:
    - United States
    - Japan
    - China
- Meanwhile, the Euro is created and issued by the Institutions of the European Union participating in the Eurozone.
- Therefore, financial unstable countries are required to seek financing to stay afloat.

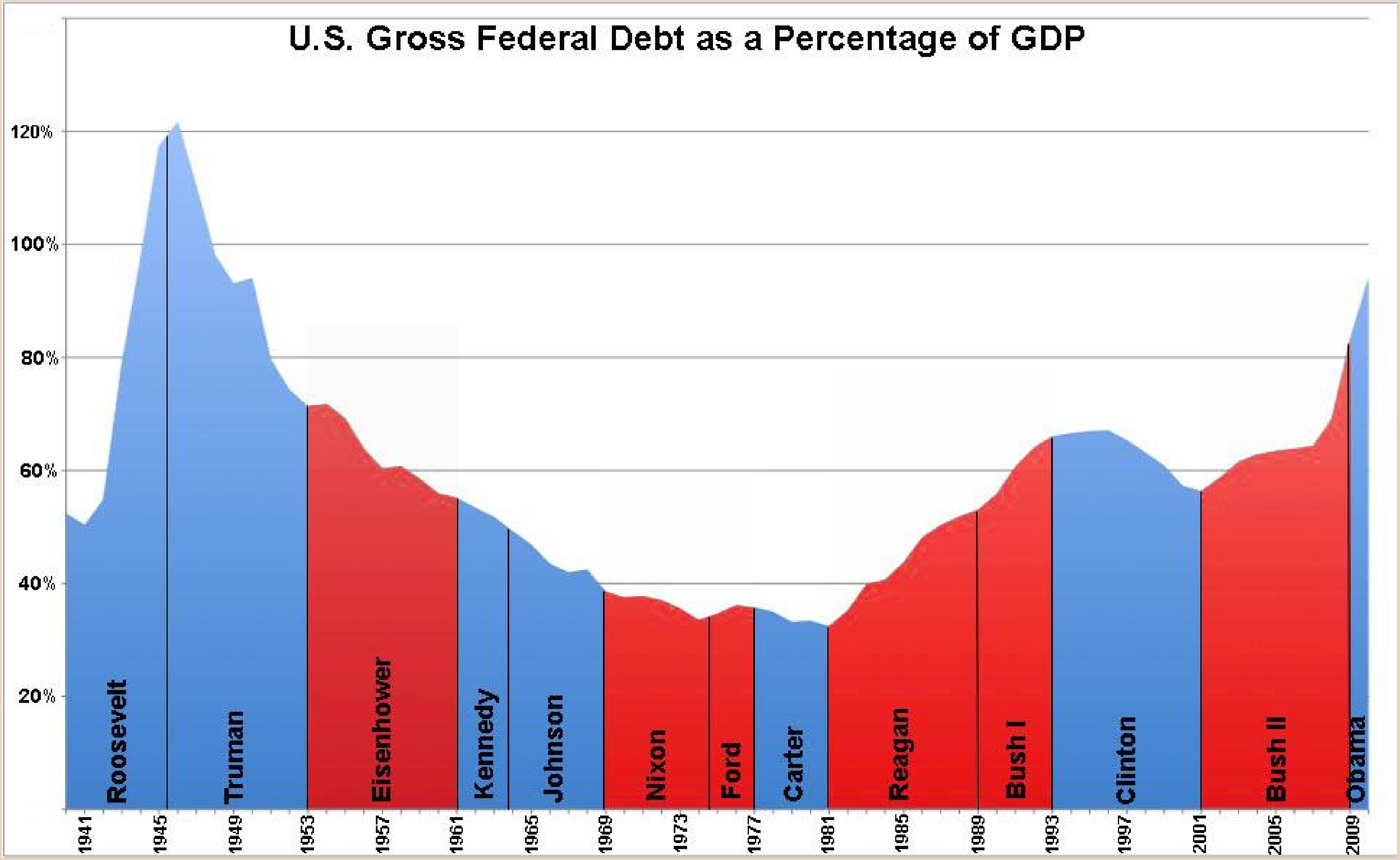
What does this mean for financials?

- Derivatives for U.S. banks are valued differently in the United States than they are in Europe creating a discrepancy in overall market valuation.

- Almost all large U.S. based banks are heavily invested in European countries.

- Therefore, a financial crisis in Europe has a direct effect on U.S. financials.

Effects of a U.S. election year:



Basic economic views for election:

- Democratic President:
  - Large government
  - Increased taxes on high wage earners
- Republican President:
  - Smaller government
  - Less taxes to benefit the overall economy

- Different presidential outcomes have different effects on the tax rates.
- Tax rates greatly influence financial sector performance.

Macroeconomics: Looking Forward

- The financial sector will not be returning the its pre-recession peaks anytime soon.
- Economic boom of past decade was greatly spurred by the financial sector.
- Almost all large banks were involved in overly generous residential/commercial mortgage lending as well as artificial asset valuations.
- Residential and commercial real estate lending is now highly regulated (conservative).

Macroeconomics: Looking Forward

- Some U.S. banks are looking to profit from the Eurozone crisis in the short term.
- If capital is invested wisely, some large U.S. banks may able to generate large long term capital gains resulting from Euro pitfalls.
- U.S. banks benefited from loan growth over 10 straight months, though it recently began to decline as of July 2012.

Potential Increased Regulation:

- The financial sector has seen a large amount of increased regulation from the recent financial crisis.
- Several other regulatory requirements are anticipated in the near future.
- Regulatory requirements typically hinder growth of United States banks.

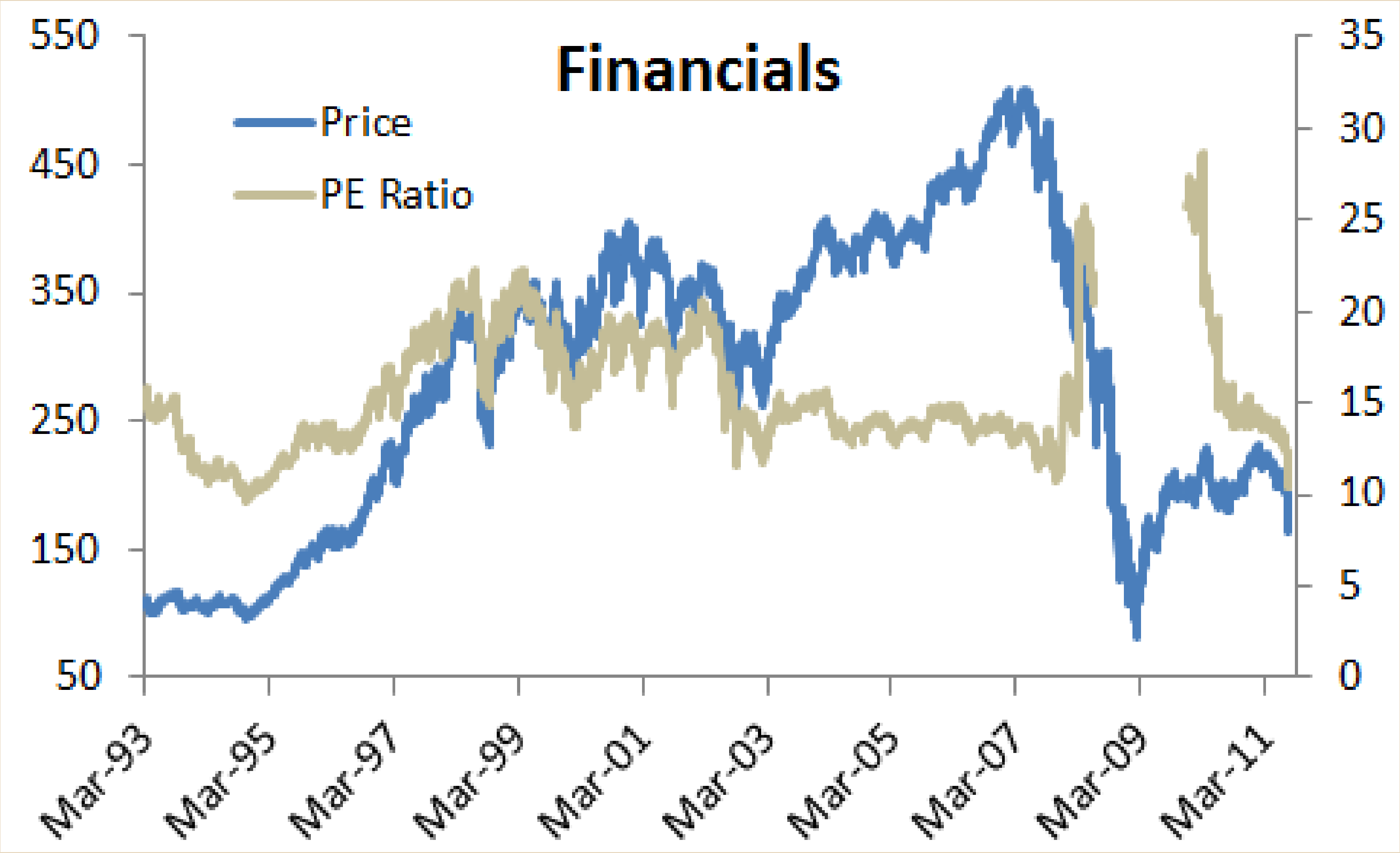
Commonly used valuation matrixes

- P/E ratio: The ratio of price per share to earning per share
  - $$\frac{\text{Market Value per Share}}{\text{Earnings per Share (EPS)}}$$

XLF Sector

- Current P/E ratio is 12 (yahoo finance)
- Indicator for growth opportunities of the sector.
- Sector Constituents P/E ratio
  - Wells Fargo & Co (WFC) 11.72
  - JP Morgan Chase (JPM) 9.54
  - Chicago Mercantile Exchange (CME) 12.33
  - All State Corp (ALL) 9.7
- Only useful to compare companies in the same industry.

Historical XLF P/E Ratio



Problems/Relevancy

- Arbitrary accounting rules set by GAAP
- Understated inventory and depreciation cost costs during high inflation times.

Relevancy

- Use multiple ratio analysis and matrixes to determine the value of sectors or stocks.

– P/S

– P/B

– P/FCF

– ROE

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