In this memo: UNCERTAINTY, FEAR & GREED | GENERAL ECONOMIC COMMENTARY | BANK ANALYSIS

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"Be fearful when others are greedy and greedy when others are fearful." – Warren Buffett

Dear Partners,

Uncertainty is one of those things that never really goes away, only our perception of it changes. When times are good the human tendency is to project those good times into the future. Right now, uncertainty *appears* high because a pandemic and its add-on effects are causing disruptions to markets for everything from businesses to paper towels. We only feel the uncertainty because it is upon us, but it's never gone. Our nation's annual remembrance of September 11th is a good reminder that huge areas of our lives can be disrupted in an instant. These so-called discontinuities, if they are at all possible – even if they are highly improbable – are *certain* to happen eventually given enough time. But we need not enter a state of permanent fear or paralysis. The job of the investor, as the Buffett quote above sums up, is to *calibrate*, to adjust for the tides that inevitably ebb and flow and which change the risk/reward calculation.

GENERAL ECONOMIC COMMENTARY

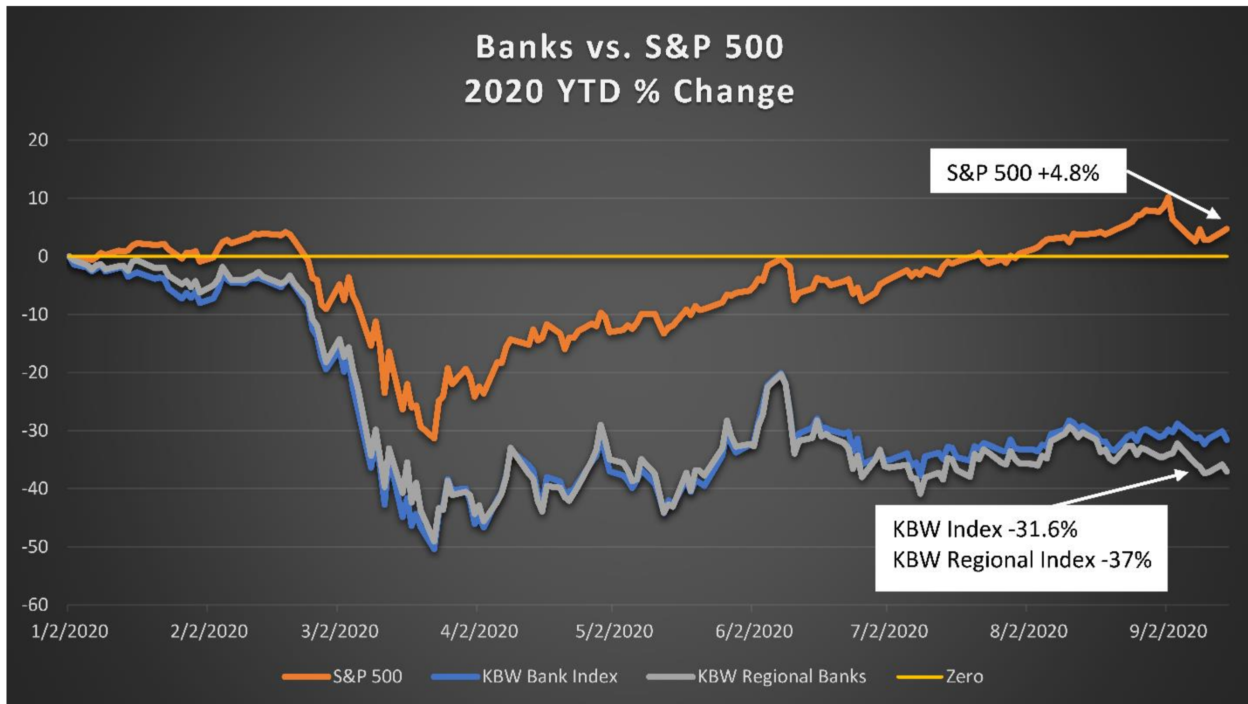
So where does that leave us today? Today we find ourselves in a strange world with a global pandemic ravaging economies and businesses juxtaposed against a market for businesses (stocks) reaching new heights led by tech darlings reminiscent of the dot-com bubble. To put it plainly: what gives? Rather than risk joining the long list of certain-sounding economic commentators opining on the unknowable I offer more questions than answers:

- When will all things currently temporary turn permanent (job cuts, unemployment, business closures)? How forcefully will these things feed on themselves? What might stop that feedback loop, and when is it too late?
- How much financial support can an economy bear without the productivity to back it up?
- How will the interest rate environment change what happens next? Which areas are being shielded by low interest rates that wouldn't survive a "normal" market for capital? How are international capital flows affecting American markets?
- Does the market know something we (I) don't about today's technology companies? Who has answers and insight into tomorrow's economy and who is just riding the current wave? When will investors realize companies must eventually turn a profit to justify their existence?

While the list above is by no means comprehensive, it's enough to give pause. Some commentators seem to think we're coming out of a recession. In my view, it feels like the pain has only just begun.

BANK ANALYSIS

Dealing with uncertainty is the daily work of the banker. It's not surprising to see the stock prices of banks suffer amid the uncertainty and very real risk of loss inherent in banks' loan portfolios. Not to mention the serious drag on profitability coming from low interest rates. Both the KBW Index and its regional index, trackers of bank stocks, are down by a third year-to-date and trail the S&P 500 by five more points beyond that.



In short, banks today are out of favor and could represent a good hunting ground for bargains. I say could because the reasons bank stocks are down do represent real risks to their businesses. Some won't survive. But amid the carnage there are likely to be good banks tossed aside. Those are the ones we're looking for. We already own two very good banks and those form the basis for our search. If we can find banks of equal or better quality, we'll buy into those at the right price. If not, we might add to the ones we already own. Here's a very high-level overview of how I think about analyzing a bank:

- <u>Return on assets:</u> Perhaps the most important broad-based indicator of a bank's quality is its return on assets over time. I like return on assets because it removes the distorting effect of leverage. It's the equivalent of looking at return on total capital (equity + debt) of a non-financial company. Return on equity for both banks and non-banks can be juiced up with leverage. Better to own the best banking operation, not the one that resorts to heavy borrowing. ROA also nicely ties in the three major categories of costs banks must

manage: 1) overhead, such as salaries and physical plant; 2) loan losses; and 3) interest expense.

- Efficiency ratio: Any business does better when it operates with low costs and banks are no different. For banks, a key metric is its efficiency ratio. The lower the better (the ratio divides non-interest expense by net interest income plus non-interest income, so a higher efficiency ratio is worse). Both banks we currently own have efficiency ratios in the 30% range, an exceptionally good result.

- Loan losses: Loan losses are the costs that show up over time. Credit losses are a part of doing business; reserved now, paid later. Imagine the confusion of a manufacturing manager who received a bill for costs that went up retroactively from two years ago. Such is the experience of a banker who must come to grips with a long feedback loop. Here I care more about actual loan losses over time than the reserve for losses in any given year (which of course should be adequate in relation to the riskiness of the loan portfolio). How good is the management team at assessing risk? Unlike non-financial companies, banks (like insurers) have costs that show up over time. A bad loan decision today might not materialize until five years down the road. The underwriting philosophy of management must be clear and focused without major changes. One bank we own has done extremely well in losing essentially no money over decades. The other operates in a higher risk category but gets compensated for it via higher rates. Both are well-operated organizations because they understand their risk category well.

- Net interest margin: Interest expense is to a bank like the cost of goods sold is to a manufacturer or retailer. Most banks are market takers with attempts to influence net interest margin a frustrating battle that can't be won. Competition for loans and deposits ensures most are competed to the margin. There are a few exceptions here, such as large national or regional banks with branch networks capturing enough market share to pay peanuts on deposit accounts.

It's virtually impossible to lead in all three categories above. The tradeoff typically occurs in exchanging a higher net interest margin for higher loan losses (think credit cards) or vice-versa. The best banks focus on the things under their control such as keeping overhead low and making sure loan losses are appropriate for the risk appetite of the bank. The best banking teams also resist the temptation to manage earnings by using the loan loss provision as a so-called cookie jar, or by taking securities gains into earnings to meet earnings targets (a particularly dumb strategy that results in needlessly higher taxes).

Tying all these together is the management team. Understanding the philosophy and incentives of management is an overriding concern – much more so than with non-financial companies. The only real protection a bank investor has is a high conviction that the senior management team is trustworthy. It's far too easy to bury problems or otherwise introduce optimism into calculations of earnings or asset quality. By the time problems come to the surface it's much too late to act.

Over the last few weeks, with the help of an intern, I've been sorting through a custom-built database of almost a thousand publicly-traded banks. With luck a candidate or two will come out of the mix representing a solid new investment opportunity.

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Wishing everyone a healthy and enjoyable autumn.

Warmly,

Adam

Important Disclosures:

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