

Opportunities in Banking

Winter 2010

Q&A

The RS Investments' Value Team has built a meaningful position in the regional bank space, premised on the Team's long-held investment philosophy that Returns on Invested Capital are essential to creating long-term value. The Team has identified what it believes to be an exceptional opportunity to invest in high-quality banking franchises at or below their downside estimation of these firms' warranted value.

In this research brief, we interview the RS Value Team's Financials Pod to gain a better understanding of how the Value Team's ROIC-based philosophy translates into their work within financials. Further, we discuss how the Team identified the opportunity within regional banks, premised on business models built on "advantaged liabilities" and "relationship lending."



RS Value Team – Financials Pod: Robert Harris, Scott Hartman, Andy Pilara, Randy Sternke, CFA

Q How does the RS Value Team's philosophy that Return on Invested Capital (ROIC) is the essential measure of value resonate in your analysis of financial companies?

A (Robert Harris) Our cash-flow focused, Return on Invested Capital (ROIC) investment philosophy is applied in exactly the same way in the financial services space as it is in other sectors. We are looking to make investments in businesses with improving cash returns that are trading at or near our estimate of downside price. We have found that improving ROIC is highly correlated with improvements in shareholder returns, and it serves as the basis for all of the RS Value Team's research across sectors.

Q Can you give us an example of how this ROIC-based philosophy has translated into an investment?

A (Robert Harris) One of the best examples of investing in improving ROIC businesses can be found in looking at the structural changes impacting the banking industry today. We believe the operating changes and refined regulation invoked in response to the recent financial crisis will ultimately improve the quality of ROIC in the banking space.

For example, we invested in a particular regional bank that, under the previous management team, was focused on high nominal return, national lending businesses. The problem with these businesses is that they house significant liquidity and credit risk that leads to volatility in the ROIC. However, as a result of the financial crisis, and a near-death experience at the bank, the company brought in a new management team that immediately focused on strengthening the balance sheet and business mix, with a sole focus on risk-adjusted returns. This change led to a significant capital raise and shift in business

for the company, which has since exited these high-risk, national lending businesses. The company is now refocused on building "advantaged liabilities" and generating "relationship loans" – two concepts that we will describe in more detail. We believe this shift will result in higher risk-adjusted returns. In sum, the company's fortified balance sheet combined with lower market valuations provided us with downside protection in this investment even when we assumed a worst-case scenario.

Q How does an understanding of "unit-level" economics help to influence your investment decisions?

A (Randy Sternke, CFA) We believe that it was our unit-level work, where we understand a business as a function of its individual components, that allowed us to avoid many of the ill-fated business models heading into this recent crisis. For example, our understanding of the cash flow profile of a pay-option adjustable rate mortgage (ARM) helped us avoid lenders active in the space. Pay-option ARMs are mortgages that allow the borrower to choose between several different payment options, one of which only covers a portion of the interest charged during the period. As banks were able to book earnings on "interest due" rather than on "payments received," this created phantom cash flows that significantly overstated ROIC. Further, these loans made the bank increasingly exposed to real estate values. When real estate values plummeted, those companies focused on this type of lending failed.

(Robert Harris) Gaining a complete understanding of how each bank makes money and manages risk at the unit level is the most important thing that we do. Our analysis is really no different than that of understanding the economics of a coal mine in the natural resources area or of a retailer opening a new store.

Q How do you incorporate downside risk assessment into your capital allocation decisions?

A (Robert Harris) Everything we do is geared toward gaining a superior understanding of the risks associated with each of our investments. We start with an acknowledgement that, as common equity investors, we are at the bottom of the capital structure, and that ultimate downside is a failure of the business model. So, in the spirit of protecting downside, we have to determine how a company could fail. Our analysis starts with the balance sheet and an intense investigation of the funding structure, with a primary focus on liquidity risk. After that, we look at capital levels and the risk of a future dilutive capital event. At this point in our analysis, we are applying extreme scenarios with regards to losses on the loan and investment portfolios, as well as material declines in interest rates and equity market levels when determining future cash flow generation and capital retention.

Q Can you provide an example?

A (Robert Harris) One of our life insurance investments has material exposure to European sovereign debt, which has become a major focus for many investors. However, we stress-tested various scenarios regarding losses on its exposure and came to the conclusion that even if the company had realized a total loss on all of its European sovereign debt exposure over the next 12 months; it would still not have a liquidity issue, would remain well-capitalized, and it would not materially displace the return profile of the business going forward. Given the market's concern over short-term losses, we were able to add to our position below our downside estimate price when the market fretted about macroeconomic debt issues.

(Randy Sternke, CFA) This is also true of our bank investments. Despite the significant loan losses taken to-date, our bank investments in many cases could withstand nearly double the losses that have already occurred and their capital and liquidity would remain sufficient. In this scenario, we were excited to be able to buy companies at or below downside estimates of the firms' warranted value.

Q How does the Financials Pod vet an idea and how does the Value Team determine which recommendations from the Pod go into the various portfolios?

A (Robert Harris) All of our investment ideas are vetted by a minimum of two primary analysts working side-by-side on a given name and are discussed with all of the Pod members in our weekly meeting. The analysts first build a clear understanding of the unit-level economics of the business and then identify key risks to both the business and a potential investment. Again,

typically these are liquidity and capital dilution. After that, the analysts perform stress tests on the various assumptions and then make a determination of downside estimates. If a name is close to its downside estimate price and it has met our other requirements regarding capital allocation and improving ROIC, then the idea is debated amongst all members of the Pod. If it is decided that an investment should be made, the name will first compete against cash, then against the lowest conviction name in the sector portfolio and, if necessary, against the lowest conviction name in the overall portfolio. Keep in mind that hurdle is high. We run high-conviction portfolios and competition for capital is tight.

(Randy Sternke, CFA) I would add that since our investment process and compensation is based on capital preservation as opposed to capital consumption, we are incentivized to get the best ideas into the portfolio. It is this concept that drives our team-level, weekly portfolio review.

Q Where are you seeing opportunities within the financials sector?

A (Robert Harris) Beginning in the summer of 2009, we significantly increased our overall weighting in financials. Most notably, we substantially increased our investments in regional banks while maintaining meaningful exposure to the life insurance space. This follows several years of minimal investment in banks due to valuations that did not reflect the risks to balance sheets and deteriorating ROIC. Our shift into banks is a function of the recapitalization of high-quality franchises and discounted valuations, which combine to provide us with downside protection even under our most draconian scenarios. We have focused our investments in banks that have built "advantaged liability" structures with low cost deposits, and where we expect to see a significant improvement in returns.

Within life insurance, we continue to focus on businesses with lower capital intensity that possess advantaged distribution structures as we believe these models generate higher returns. With fortified balance sheets and valuations that remain at or below our downside estimate prices, we continue to find attractive investments in the life insurance space.

"The value drivers of sustainably successful companies are advantaged relationships"

Q You've mentioned your investment in banks several times, can you provide a high-level understanding of what drives value at a bank?

A (Randy Sternke, CFA) In our view, the value drivers that protect downside and produce sustainably strong returns are 1) a balance sheet supported by what we call "advantaged liabilities" and 2) a lending culture focused on "relationship lending."

Q Could you elaborate on what you mean by "advantaged liabilities" and "relationship lending?"

A (Randy Sternke, CFA) Each really boils down to the culture underlying the institution. Let's start with "advantaged liabilities." In a highly-levered business model, such as a bank, liquidity is the linchpin to protecting downside. If there is anything that this financial crisis gave us, it is an even deeper appreciation of the scarcity value of liquidity in periods of crisis, which is precisely when you need liquidity. Therefore, a bank's best long-term return on committed capital, in our view, is investing in a strong core deposit franchise by both building a retail-focused branching effort and garnering the deposits of the very businesses to which the bank lends.

That comment really segues into our views regarding "relationship lending." Credit risk runs a close second to liquidity when we look at protecting downside in our

bank investments. We believe that the best way for a bank to manage credit risk isn't through the hedging and diversification strategies undertaken by transactional lenders, but rather by having an in-depth knowledge of the borrower. That is why we have focused our investments on franchises which do just that.

Q So when you are looking at banks, how do you determine which institutions fall into these two categories?

A (Randy Sternke, CFA) There are several things we look at such as the mix of deposits and loans on the balance sheet. However, if I could circle back to my earlier comment, the most important piece of the puzzle is the culture of the institution and management's understanding of returns on capital. It isn't easy to build a core deposit franchise or new lending relationships, which is why so many institutions went awry chasing quick, inflated returns. However, institutions with a patient culture focused on long-term value creation and proper risk management, stayed the course and proved the merits of the model by not only staying in business, but continuing to thrive and deliver attractive returns to shareholders.

(Robert Harris) To add to that, we also look for red flags. We broadly define the business of banking as a business of risk management, so something that might suggest an oversight in risk management will always be a point of concern. For instance, significant expansion of business lines or aggressive growth into new businesses or markets will always lead us to ask how risk management was incorporated into the strategic planning, and how a company's risk management team might have changed course to accommodate the initiative. The answers to those questions are key to understanding both the culture of the institution and management's commitment to being disciplined stewards of shareholder capital.

Q What types of opportunities has this financial crisis created for you?

A (Randy Sternke, CFA) I would broadly say that there have been two types of opportunities that we have identified. The first and easiest to explain is the classic "baby with the bathwater" scenario where a high-quality franchise with improving ROIC has simply been sold down by the market based on macro-level fears. This is exciting because we're able to purchase stakes in franchises that we've admired throughout our entire careers but have never had the opportunity to own, because, it is our view that the market has historically overpaid for "quality." The second opportunity is focused on well-positioned core franchises with improving ROIC that had some credit missteps but have replaced management and replenished their coffers with new capital.

Q In a new management scenario, how do you get comfortable with a franchise's opportunities for overcoming its recent failures?

A (Randy Sternke, CFA) In these scenarios we take a very critical look at the balance sheet, determining the liquidity and capital risks given draconian credit scenarios. In addition to scouring company releases, we visit bank personnel and local competitors, while also building relationships with non-bank lenders, asset acquirers, and customers of the bank. After we are comfortable with the balance sheet, we turn our attention to the decision-making process utilized by prior management. Obviously, replacing the key decision makers is a start, but it is more important to us to understand how those past decisions were made and how the process has been changed.

(Robert Harris) The focus of these discussions, again, has to be on risk management. We have to understand who is now involved in the capital allocation process, how the risk management function of the institution has changed, and how new management has instilled a commitment to driving enhanced risk-adjusted returns throughout the organization.

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Q This crisis has obviously changed the rules of banking from a regulatory and legislative point of view. What is your take on regulatory reform?

A (Randy Sterne, CFA) We can certainly debate the particulars, but, in general, we view the effort favorably. The banking industry is one of the most critical to the health of both the U.S. and global economies and it is important to ensure that excessive risk taking and structural weaknesses do not pose another significant threat to the global marketplace. In our view, the best way to insure against excessive risk taking is to regulate away the attractive economics by instituting higher capital requirements on risky business practices. We just hope that regulators don't go so far as to displace the economics of productive lending. This would be a costly unintended consequence, potentially further weakening our economy and impairing long-term economic expansion. This risk is not lost on us. In all of our assumptions used to determine our downside value, we make the broad assumption that regulations will impair returns going forward.

Q Any concluding thoughts on the financial sector?

A (Robert Harris) We believe this is a very exciting time to be a truly bottom-up, long-term oriented investor in the financial sector, particularly in the banking space as this appears to us to be an exceptional opportunity. It could be a bumpy ride, but we believe that our strict adherence to investing in franchises focused on high-quality, long-term value drivers will serve our investors well over the longer term.

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