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Should Jesse Litvak and his clients cover equities?

By Jeff K. Davis

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Ex-Jefferies & Co. trader Jesse Litvak is on trial in federal court, accused of lying to his institutional clients about the value of the bonds he was peddling. Apparently, the government just learned that some bond salesmen are aggressive or, depending upon one's point of view, really good salesmen.

Bloomberg reports that one portfolio manager told Litvak he could not pay more than 57 cents on the dollar for the bonds because the expected return would be less than 10%. The investor, Joel Wollman, admitted upon cross examination that he told another broker that his maximum price was 58 to achieve the minimum 10% return. So the client seems to admit to lying to the trader who denies lying to the client. In Wall Street's vernacular, the prosecutor might substitute the phrase "bid and ask" that I bet the jury could understand rather than modified duration, convexity, default probabilities and other arcane concepts.

In theory numbers do not lie. This should be especially true for bonds, though we can let the IRR based upon 57 vs. 58 slide due to presumed rounding. Fixed-income math usually is not like that for a stock where the story may have a large sway on investors' perceptions about future cash flows and an appropriate discount rate. The price paid for the bond, coupons received during the holding period, and cash received at maturity or proceeds from a sale prior to maturity are the relevant factors to calculate the return. Of course, credit risk, prepayment optionality and the like can impact one's view of future bond cash flows.

So do brokers, managers and investors fully level with themselves and each other about equities and what is possible to justify a higher price? Equities offer vast upside over time if key variables go right. The optionality of outcomes and the absence of a contractual "maturity" make evaluating equities a much tougher proposition than evaluating a bond. When there is a story attached to the shares, all the better because the narrative rather than the numbers is what matters in the near term.

If equities are about what is possible, do recent results matter? And how about reported results vs. "core" results — i.e., earnings excluding the bad stuff? It seems like an apropos question for a lot of industries where the top line is flat and companies are pulling rabbits out of the hat to maintain some semblance of EPS growth. Investors focus on what may be, not on what was other than to triangulate what could be. The quarterly conference call is just that: a discussion of 90-day results with little if any discussion on the past year's results during the final quarter of the year.

But there is something to be said for the most recent fiscal year, or last-12-month earnings. Over time, the fiscal years serve as a record of managements' stewardship and a roadmap as to why the company's shares produced a certain return.

And LTM results are useful to frame earning power, though earning power is another concept that is subject to misunderstanding. I would argue there are two forms of earning power. One is more akin to nirvana that the Street likes to focus on — i.e., how much money can the company make and how high can the shares rise if most everything goes right. In terms of M&A, a banker might tell the seller what is hoped for is "stretch" pricing, but the range of likely outcomes is something less. As an equity investor, stretch earning power is what we hope for, though when stretch earnings are achieved, the market may capitalize the earnings with a pedestrian multiple.

The other form of earning power is more akin to average earnings (or margins) through a complete business cycle. That form of earning power may not be easily sold because it implies less upside vis-à-vis current results, especially in an environment such as today's when many banks have very low credit costs.

JPMorgan Chase & Co. management teed up its view of earning power at its investor day on Feb. 25. Management put forth a simulation in which pro forma net income could increase to $27 billion within four to five years from $18 billion as reported and $23 billion of "core" net income in 2013. The implied increase from "core" net income was not heroic as measured by an approximate 4% compound annual growth rate over five years, though the CAGR of more than 10% when measured from 2013 reported net income might be heroic given JPMorgan's size and the difficulty that large companies in mature industries face in maintaining high levels of growth.

My second thought was that JPMorgan is still an inexpensive stock absent another recession, trading for 8x implied earning power of about $7.00 per share assuming the share count remains unchanged at 3.8 billion. The third observation was that management's roadmap as measured by tangible book value per share has been excellent — it increased at a CAGR of 11.6% to $40.81 per share at year-end 2013 from $18.88 at year-end 2006 in an operating environment that leveled competitors Citigroup Inc. and Bear Stearns.

Earning power is a concept based upon a set of assumptions. One key assumption made by management was "normalized rates & incremental earnings from investments" that contributed $7 billion to earning power vs. current earnings. Management based the increment upon higher short rates as implied by the forward curve and loan growth less incremental credit costs. This increment was partially offset by normalized credit costs and the drag from the regulatory and legislative mandates that have been heaped on the industry.

Could this scenario play out? Of course it can. It could be even better, rendering JPMorgan's shares as really cheap. Equity investors have to believe in upside and calculated risk taking, otherwise there is no reason to invest. But it could go the other way, too. Short rates could remain anchored to zero for many more years in spite of the very fallible forward curve, loan growth could remain tepid, and/or the economy could enter a recession and thereby push credit costs up. Alan Greenspan's "great moderation" era that spanned 1989-2005 when bank ROEs were higher and stable has given way to something else.

JPMorgan's and many other bank's LTM results may be closer to earning power than management and investors want to admit. Legal costs will fade over the next few years, but credit costs may increase without higher short rates supporting a better NIM. JPMorgan's $18 billion of net income in 2013 equated to a return on tangible common equity of 11%, or 15% on $23 billion of core earnings. Management offered a range of ROTCE of 15% to 16% based upon the $27 billion of earning power. CEO Jamie Dimon later offered 14%-plus as a possibility. Maybe a more conservative view of through-the-cycle earning power is 12% to 14% in the new world order? If so, that level of earnings is still a considerable premium to the yield on the 10-year U.S. Treasury.

Nearly 20 years ago, I was working on an acquisition in which Deposit Guaranty, now part of Regions Financial Corp., was considering buying a client. It was then when I learned an important lesson about markets. The conversation turned to Deposit Guaranty's recent results, which were a little short of Street expectations for reasons that I do not recall. I remember the banker in so many words unintentionally getting to the root of the essence of Wall Street's trading mentality. He said it does not matter because by July (it was then May) everyone's focus will be on next year, not the last two quarters of the year. He was right.

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