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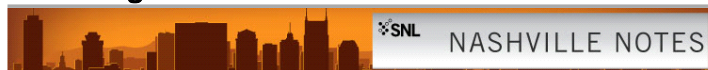

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One quibble with Bill Gross regarding Citigroup

By Jeff K. Davis

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March 9, 2016, saw a number of press articles about the seventh anniversary of the current bull market and the then-end of a savage two-year bear market. A couple of days before the March 9, 2009, bottom I was driving on I-10 near New Orleans when a reporter (not from SNL) called to discuss Citigroup Inc. The basis for his story was to compare Citigroup's then pre-reverse stock split share price with a $3 ATM fee. Citigroup's share price during the first week of March was trading just above $1 per share, or near $10 per share adjusted for the 1-for-10 reverse stock split that occurred during May 2011. With the prospects of nationalization of large U.S. banks off the table, my immediate reaction to the reporter's call was the bottom in the market was in, but the upside was unknown.

Bill Gross writing in his March 2016 Investment Outlook has a dour view of the upside. He argues that the collapse in bank stock prices through February (but before the March rally) was not about investors waking up to credit risk associated with the energy complex, but rather investor recognition that earning power is impaired. No kidding. I and many others have thought that for years.

Gross invoked a super nova in which "finance itself is burning out like our future Sun" as a result of NIRP and ZIRP. Thematically, his outlook was about a slow asphyxiation of banks, insurance companies and pension funds. My take is that we are in a rabbit-hole world where central bankers are testing the "don't hold yourself back" adage by pushing short-term policy rates deeper into negative territory and creating digital reserves to buy sovereign bonds and (now) corporate bonds. In arguing impairment, he cites the February 2016 lows compared to the pre-crisis highs in 2007 for a number of banks. Citigroup was over $500 per share compared to a February closing low of $34.98 per share, which represents a three-fold increase over the March 2009 low. Bank of America Corp. was around $50 per share vs. a February low of $11.16 per share. It is a reasonable proposition, but with a caveat.

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The low-teen ROTCE that many banks post today is down from the upper teens before the financial crisis. And I can argue that earning power for many banks today is somewhat overstated because credit losses are near what presumably are cycle lows. However, I have one quibble with Gross when arguing for impairment based upon current share prices versus those prior to the financial crisis: credit performance and capital replenishment. Many banks incurred significant dilution to recapitalize by having to issue shares when their share price was very low. Of course, the long-term historical price charts are ugly.

Citigroup is exhibit A. Its common share count increased six-fold to 3.0 billion by year-end 2012 from 491 million at year-end 2006 because the company was forced to raise a massive amount of equity at low prices in the aftermath of the financial crisis. Tangible book value fell to $42.69 at year-end 2009 from $162.43 per share at year-end 2006. Also, Chuck Prince's dance-inducing earnings from securitizing sketchy mortgages disappeared. What's left? Core banking: spread-based lending, treasury services, underwriting bonds and equities, and foreign exchange trading among vanilla offerings.

Citigroup is an extreme example, which probably is why its long-term price chart is shown in Gross' missive. Bank of America is not as extreme, but excelled at destroying value too. Its outstanding common shares increased to over 10 billion by year-end 2010 from 4.5 billion at year-end 2006 while tangible book value fell to $10.11 per share at year-end 2008 from $13.26 at year-end 2006. Of course, the 2008 acquisition of Countrywide Financial Corp. has been an incalculable disaster for shareholder value. The what-if alternate history for Bank of America might have it positioned alongside JPMorgan Chase & Co. and Wells Fargo & Co. had it not acquired Countrywide.

Among the more common dilution stories is SunTrust Banks Inc. Its shares traded above $80 during the first half of 2007. The closing low was $31.36 per share during February 2016. SunTrust's shares were overvalued in 2007 given the developing storm, and they may have been undervalued in February absent a coming recession; however, the long-term price chart has to be considered in conjunction with the dilutive impact of the post-crisis share issuances in which its common shares increased to 537 million by year-end 2011 from 355 million at year-end 2006. Tangible book value declined to $22.59 by year-end 2009 from $28.66 per share at year-end 2006. Had SunTrust not been required to raise so much capital at low prices perhaps its shares would trade around $50 today. That may be faint praise given where the shares traded pre-crisis, but dilution nonetheless matters.

Commercial and even investment banking as practiced by the likes of Raymond James Financial Inc., Stifel Financial Corp. and even JPMorgan Securities LLC is supposed to be a mundane financing business, akin to amateur tennis in which the goal is to keep the ball in play and wait for the opponent to make an error. The business is supposed to be borderline boring. The key to long-term value creation is to avoid big credit issues, especially those that lead to costly capital issuances at low prices.

Back to Gross' imploding star concept for finance. I whole-heartedly agree that the industry's earning power has been impaired. The long-term trajectory from here is a much lower slope than in past years, and it will be even lower if the Fed opts for NIRP to combat the next recession. Investors will have to determine entry prices accordingly. Low-teen ROTCEs and high-single-digit ROEs for banks will head lower whenever credit costs turn higher, but it could be worse. Fixed-income investing appears to be a sphere in which the compounding of value through reinvesting interest income has been relegated to the history books as a pre-21st century concept.

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