Finding Growth in a Non-growth Sector

For RASARA's manager Raymond Stewart, bank stocks are not a cyclical play related to interest rates, but an ongoing investment opportunity. Identifying future mergers and acquisitions in the sector or finding interesting niche banks with strong fundamentals are only some of the ways in which RASARA finds growth at unexpected places.

Q: ***What is your investment philosophy?***

A: We are value investors with a twist. The uniqueness of our approach is the focus on the US banking and financial services sector. We believe that superior risk-adjusted returns can be generated by selectively investing in small and mid-cap banking and financial services companies. I'm looking at companies with market caps ranging from $500 million to about $20 billion. That is just about every name in the field with the exception of CitiBank (C), JPMorgan Chase (JPM), or Bank of America (BAC).

The banking industry is considered to be a fairly slow growth sector, but it has continuously generated earnings growth from 8% to 11% per annum and dividend yields ranging from 2% to 4% per annum. The sector has produced annual total returns of 10% to 15%, compared to the broader market returns of about 10% over the past 30 years. This is something that most people are not aware of.

Also, the banking industry often has been a hot bed for merger and acquisition activity. Ten years ago there were 14,000 banks in the country. Today we have 9,000 and expect that number to contract to 6,000 over the next 10 years. There are from 200 to 300 mergers a year. Typically, these mergers occur at 15% to 40% market premiums. I like to buy banks at P/Es ranging from 10 to 13 times earnings, which I believe eventually will either trade or be bought out somewhere around 15 to 20 times earnings.

I believe that the greatest opportunities in the banking sector are in the small and mid-cap stocks. Because of their size, they do not receive much coverage from Wall Street researchers. That provides us with the opportunity to identify and take positions in stocks that are undervalued.

Investors turn to RASARA to accomplish a number of different objectives, such as adding total return to the market-like returns of their core equity allocation. Bank stocks also serve as a buffer to the downside risk in a broader core equity market allocation. Most importantly, RASARA offsets the underexposure of investors to a sector that has historically outpaced the broader equity benchmarks.

Q: ***What is your universe in terms of loan portfolios, regional exposure, commercial or individual banking? For example, can Capital One, which is credit-card company, or General Motors Acceptance***

RASARA Strategies, Inc.

Fact Sheet

Website	www.bankstockinvestor.com
Address	RASARA Strategies, Inc. 160 North State Road Briarcliff Manor, NY 10510
Tel. No.	914-762-8777
Inception	1/1/97

Portfolio

Total Assets under Management *	$ 203.5
Avg Mkt Cap ($ Weighted) *	$ 6,845
Average Price/Earnings Ratio	15.1
Average Price/Book Ratio	200 %
Turnover Ratio **	Low

Risk

Beta	0.91
R-Squared	0.67
Ann Std Deviation	15.48
Sharpe Ratio	0.67

Returns vs. S&P 500

	RASARA	Index
1 Year (Cum.)	7.1 %	6.3 %
3 Year (Ann.)	11.6 %	8.2 %
5 Year (Ann.)	18.0 %	-2.4 %
Since Inception	16.2 %	7.4 %

Returns vs. S&P 1500 Bank Index

	RASARA	S15BANXX
1 Year (Cum.)	7.1 %	7.9 %
3 Year (Ann.)	11.6 %	9.1 %
5 Year (Ann.)	18.0 %	10.4 %
Since Inception	16.2 %	7.5 %

Portfolio Manager

Raymond C. Stewart	Jan-1997

** millions*
*** Performance figures are annualized and reflect reinvested distributions and gross of fees.*

Data through: 06/30/05
Source: Bloomberg, RASARA Strategies

Q&A
TICKER's Choice

Corporation or SunTrust be part of your portfolio?

A: I'm more inclined to go into a bank that SunTrust (STI) would be interested in acquiring at some point. For example, Atlanta-based SunTrust acquired Tennessee-based National Commerce, which had been in our portfolio for a number of years.

My interest is in small to mid-cap regional banking companies rather than credit-card or insurance companies. In terms of overall opportunity, I consider the small and mid-cap banking sector an investing sweet spot. You have historically stable earnings growth and from time to time you experience a considerable amount of merger and acquisition activity. That's RASARA's investment focus.

For example, I owned Summit Bancorp in New Jersey, which was acquired by Fleet. I chose to hold on to Fleet, which was subsequently acquired by Bank of America (BAC). We buy one bank and if we like the future prospects of the acquirer, we hold on to it and it is subsequently acquired by another bank.

The beauty of investing in small and mid-cap banks is that you don't need a merger to take place in order to make money. With rumors of consolidation, like in the cases of Wells Fargo (WFC) and Golden West Financial (GDW), two California banks, you witness a shift in perceptions, and often valuations are driven by perception. Someone like me thinks that this consolidation doesn't make sense, but that's not going to stop me from exploiting possible price movements.

Q: ***What were the factors driving this consolidation historically and forward-looking?***

A: If you compare the US banking industry to Canada, Europe, or the major Asian countries, you'll find a handful of banks in these developed countries and 9,000 banks in the US. Comparatively speaking, by number of banks per million people, the US is considerably overbanked.

Banking industry excess capacity limits its revenue growth prospects generated by economic activity. Revenue expansion can be achieved via consolidation of smaller institutions. Through acquisitions, banks are able to provide services and operate more efficiently with much lower expense margins.

Q: ***In many ways the banking sector reflects the economic activity structure in the country. In the US small companies drive the bulk of economic activity in terms of transactions. Even though we may be overbanked, could competition still be reasonable at a local level?***

A: That's very true. On the one end, each year 200 banks merge or apply to. On the other end, 100 new banks are formed each year, mainly community-based banking institutions. Consolidation of a couple of entities tends to create excess management. This management typically ends up going out and forming new banks. From the consumer standpoint, consolidation leads to depersonalization and has fostered a demand for more personal banking services at the lower end of the spectrum. That's why these small community-based operations are formed each year.

Q: ***So you mainly invest in acquisition targets before they become targets?***

A: Yes, but that is just part of it. I'm not just looking for takeover targets. The broader market tends to overlook the opportunities in the banking industry. It treats the industry as a seasonal or cyclical play as opposed to an ongoing play, and that's what makes me different from a lot of the other managers. My mandate is to look at the banking sector, and I find value in the sector regardless of the phase or the state of the economy.

Most investors think in terms of the impact of interest rates on the net interest margins of banks. Typically, investors rush into bank stocks when they think margins are going to expand and run out on the expectation that margins may contract. But it is really not that simple.

There are two components to bank revenues. Banks derive net interest revenues from commercial and industrial loans, small business loans, consumer lending, commercial real estate lending, and mortgages. But another vehicle is the non-interest revenue, which includes service charges on deposits, banking fees, trust operations, insurance and brokerage operations. The two components together, within an investment portfolio, create a less volatile revenue stream than the typical investor realizes.

A traditional bank would have net interest revenue from 75% to 80% of total revenues A more diversified bank like Fleet had interest revenue of 50% to 75%. Some specialized or niche banks, such as State Street Bank (STT), which is considered a processing or trust bank, or to a degree the Bank of New York (BK), have net interest revenue of less than 50%.

When I'm looking at the banking industry, I see something very different from your typical investor. It is not a homogeneous group that reacts in the same way to the economy. I follow around 700 uniquely different banking institutions. At some point of time, every bank in that sector provides value. My objective is to identify it.

Q: ***Could you explain your portfolio construction process?***

A: I currently manage around $200 million in institutional money. All of it is devoted to banking and financial services companies 97% of portfolio allocations are in banking companies. Depending on the size of the account, there would be from 20 to 50 banking companies in an account.

At RASARA we have historically weighted our investment allocation. We like to invest about 70% in diversified and specialized banks and 30% in traditional banks. We have structured our portfolio in such a way that we are not impacted by interest rates as much as the broader market would expect for someone holding a bank portfolio.

We identify banks with investment themes that may positively impact their market value and banks with low P/Es and good fundamentals. We follow a value-oriented approach to investing. We start with about 700 stocks of our banking universe, then narrow it down to about 50 and subsequently to the best 40 or 20 names that we think provide the best price appreciation potential.

Q: ***Do you set a price criteria for your buy or sell discipline?***

A: Yes. When we narrow the bank universe down to the best names, we apply proprietary valuation analysis to come up with upside targets. We may apply a buyout or a takeover scenario or a peer-group analysis to identify what bank looks cheap in a certain sub-sector. If the bank has a low P/E, we develop a reasonable scenario where it could attract a higher P/E and value it on that basis. For the most interesting candidates once I determine their intrinsic value, I try to buy them at a discount of 20% to 40%.

Once I establish a buy point I will sit and wait patiently. I wait for bad news. I also employ technical analysis to cut some of my downside risk when I finally take a new position in a company.

Q: ***How is your research process different? Do you combine quantitative and the fundamental research?***

A: Yes. We typically weed out all the micro-cap community-based banks. That leaves us with a universe of about 100 names. We conduct research to determine which geographic sectors of the US banking industry hold particular investment promise And we look at the types of issues that might impact the companies. Since I've got 25 years of experience at this sector, I am not afraid to make my own prognosis in terms of looking beyond the horizon.

New York Community Bank (NYB) is a good example of how I invest in a stock. The stock price is down about 45% from its 52-week high based on asset liability mismatches. The company has a dividend yield of about 5 percent. I am earning the 5% dividend yield while waiting for either a takeover catalyst or for earnings to rebound to its historical 10% to 15% range.

I also like to look for companies that have certain proprietary skills or a business niche. An example of this is United Commercial Bank (UCBH). It is not a widely followed bank. On the surface it looks like a typical small-cap banking company, but it is unique in providing services to the ethnic Chinese community in San Francisco; and now it is trying to expand in the Washington area. It has been growing earnings from 17% to 20% per annum. I have made a lot of money in the stock over time.

Q: ***What are the risk-related issues you deal with?***

A: RASARA builds portfolio diversification at multiple levels. In terms of revenue generation, we look at banks based on net interest revenue and non-interest revenue. A large portion of the banks we invest in tend to be either diversified or specialized banks.

We also construct client portfolios with geographic focus on the business – locally, regionally, and nationally. You can take any particular state and I am considering whether or not there is any interesting investment prospect. On a regional basis, I might anticipate a pick up in merger and acquisition activity in a certain area. For example, in the past the southeast and the midwest were fairly active areas in terms of mergers and acquisitions.

Small and mid-cap banks make up roughly 80% of a client's portfolio. Large-cap banking companies account for about 20% of the portfolio. The large-cap bank holdings resulted from smaller banks we held being acquired by large-caps, and I elected to keep the acquirer until it reaches a certain price target.

There is also the issue of credit or asset quality risk. We look to mitigate this by investing in banks that have very conservative underwriting procedures. With our diversification process we are not putting all of our eggs with one or two banks or any particular region in the country. ▮

TICKER Staff

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about Raymond Stewart

Raymond C. Stewart, founder and Chief Investment Officer of RASARA Strategies, Inc., has been in the investment business for over 25 years.

Starting as a part time employee at Salomon Brothers, Inc. in 1979 while attending graduate school, Mr. Stewart was responsible for developing banking industry statistical databases. In 1980 he accepted a full-time position at Salomon Brothers as a securities research analyst, specializing in banking industry companies. Instrumental in refining and adding coverage to the research department's banking industry product line, Mr. Stewart was a pioneer in applying new valuation techniques to bank stocks.

In 1983, he joined Warren Marcus, a former Partner at Salomon Brothers, and helped form the investment management firm WRM Equity Management, Inc. Mr. Stewart continues to act as a co-manager at this investment management firm that follows a higher risk/higher return bank stock investment strategy than RASARA.