

## Following Financial Stocks--Using the Stock Selection Guide

There really is not as much difference between evaluating an industrial company and a financial stock as there may appear to be at first glance. Consider the following similarities. The names are different, but the investment concepts are the same.

- Producers of goods buy raw materials and parts to manufacture products which they sell at a profit. The difference between their costs and their selling prices is a pre-tax profit. Similarly, banks borrow money from depositors and bond holders, and they lend to borrowers and make other investments. They make money on an interest rate spread.
- Regulatory agencies require banks to have a certain percentage of their capital in the form of shareholder's equity. Lenders balk when an industrial company leverages its balance sheet with too much debt.
- An industrial company or retailer can cut into profits from obsolete goods or inventory shrinkage. Similarly, a bank's profits are adversely affected if borrowers do not repay and the bank has to write off all or part of a loan
- If prices of raw materials or parts for an industrial company change faster than its selling prices, profits are affected--either favorably or unfavorably depending on the direction and magnitude of the change. Likewise, if interest rates for deposits fall faster than rates charged on loans, a bank's profits improve. If deposit rates rise faster than a bank can raise the interest rates it charges its borrowers, its profits suffer.

In place of sales for an industrial, look at total income for financial stocks. Total income includes interest income and other fees. Pre-tax profits and earnings are similar to an industrial. These can be plotted on the front of the SSG to get a visual picture of rate of growth; steady or cyclical.

In addition plot book value per share. Unless book value is growing, it will eventually limit the rate of growth of earnings because of the restraints imposed by regulatory authorities on capitalization ratios. Finally, plot dividends per share. This is an expression of the board of directors feeling of future growth. Directors like to play it safe and retain adequate capital for future growth and liquidity.

Try forecasting the future growth of EPS by one of these historical growth rates: EPS; book value; or dividends, whichever is the lowest. When a bank has grown by acquisitions, be careful of the historical growth of total income as an indication of future growth of earnings.

In addition to calculating the return on equity capital as a measure of management's ability to control costs. look at return on total assets. A return of around 1% is superior but be careful. If the ratio is too high for a period of time, there may be too many high-risk loans earning abnormally high interest rates. High interest rate returns can be more than offset by bad loan charge offs in the future. Be sure to look at average returns over a long period of time.

The estimated future high price for a financial stock is computed the same way as for an industrial. Multiply estimated earnings per share in five years by the adjusted average high P/E ratio.

Financial stock prices tend to be interest rate sensitive, moving inversely with interest rates. Actually, P/E ratios generally move inversely with interest rates for all stocks. Obviously, your judgments are going to be influenced by your outlook for future interest rates. Do you expect a prime rate of 20.5% again?

As with an industrial stock, good valuations are found when the current P/E ratio (based on estimated EPS twelve months out) is less than either the adjusted average P/E ratio or the signature P/E calculated from

the median high and low P/Es. An upside/downside ratio of 3 to 1 or better puts the odds of reward vs. risk well in favor of the investor.

In addition to the SSG, it is wise to look at the latest annual and quarterly reports. Look for losses on loans sold that are being amortized for the life of the loans. Accepted accounting practice matches income (or losses) against revenue in the same time period. Amortizing losses presents a distorted and unsound view of the balance sheet and income statement.

Non-performing assets are loans where interest is past due 90 days or longer, or they are not being paid on schedule or at a reduced rate. Calculate non-performing assets as a percentage of total assets. The national average is 1.94%. This ranges from as low as 0.48% in North Carolina to as high as 6.51% in Alaska, a state hurt by the depression in the oil and gas industry. Look at the trend of non-performing assets. Avoid banks whose non-performing assets are rising or above average.

Also look at the size and trend in the loan loss reserve. Is the reserve growing relative to loans outstanding or non-performing assets? If so, chances are the company is doing a good job of protecting itself and its shareholders from potential credit losses.

With banks, the sum of the equity capital and the reserves for loan losses as a percentage of total assets is called primary capital. Regulatory authorities require primary capital of at least 5.5% to 6% depending on the types of stock and debt issued. There has been discussion to raise the ratio for lending institutions carrying high risk loans.

Avoid banks that are skirting the edge of permissible limits of primary capital. It's nice to have a cushion in the case of unexpected events.