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2. Economic and Financial Analysis
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Financial Sector Overview

• Includes the many financial services companies of the S&P500

• **F I R E:**
  • Finance
  • Insurance
  • Real Estate
Financial Sector Industries

• Banks
• Capital Markets
• Consumer Finance
• Diversified Financial Services
• Insurance
• Real Estate Investment Trusts (REITs)
• Real Estate Management & Development
• Thrifts & Mortgage Finance
Largest Companies in the Sector

- Investment Management: BlackRock Inc. ($4,645.4 Billion AUM)
- Commercial Banking: Bank of America Corporation (11.13% market share)
- P&C Insurance: State Farm Mutual Automobile Insurance (12.1% market share)
- Retail REIT: Simon Property Group Inc. (2.5% market share)
Financial Sector Performance
Financial Sector 2016 Outlook

• During early 2016, "herd behavior" influenced mass-selling
• Recently, investors seem more rational & confident about the market
• Despite early-year underperformance compared to the S&P500 index, many analysts believe the sector's 2016 performance will exceed that of the market (ex: Charles Schwab Sector View: Outperform)
  • More M&A action
  • Further business consolidations
  • Greater investment activity from raised interest rates
Economic and Financial Analysis
Cycle, Trend, and Future Performance Outlook
Economic Cycle Analysis

Four Stages

1. Contraction *(Equity goes Bear)*
2. Recession *(Trough)*
3. Expansion *(Equity goes Bull)*
4. Peak

Current 2016 Stage ~ Expansion
Economic Analysis

Macro Factors

• Low Interest Rates
  • Average age for first home buyers has increased meaning less loans are demanded from the banks
  • Lower incentives for deposit investment products
  • Lower NIM for banks
• China's Growth (Or lack of)
• Global Oil Market
Economic Analysis

Macro Factors

- Lower Oil Market
  - Global Oil Market
  - S&P 500 Financials Index
Financial Analysis

S&P 500 Index ~ $2,051
S&P 500 Financials Index ~ $870
Financial Margins 2015
S&P 500 Financial Index
Financial Sector and S&P 500 Dividend Performance

Large-Cap Financial Dividends
- 2.3% Dividend Yield (Ranks 7th in the S&P 500 sectors')
- 15% Dividend Growth (Ranks 1st in the S&P 500 sectors')

Small-Cap Financial Dividends
- 3.4% Dividend Yield (Ranks 1st in the Russell 2000 sectors')
- 16% Dividend Growth (Ranks 1st in the Russell 2000 sectors')
P/E and Forward P/E Valuation Analysis

Starting our history backlog, the Financial sector maintained a below-average forward P/E multiple between 2000 and 2008. When the markets collapsed and high volatility occurred, the Financial sector and its forward P/E's sky rockets near a 1.2x multiple. Since then, the financial market has stabilized and forward P/E's drop below the average of around 0.8x multiple.
Business Analysis
Business Analysis - Themes

1. Pro-Cyclical = Beta > 1
2. Mature and Competitive = Price Pressure
3. Linked to Economic Health = GDP Growth
4. Higher Interest Rates
Business Analysis

Financial Sector Segmented Into Three Largest Categories

1. Commercial and Investment Banks
2. Life and Property-Casualty Insurance
3. Brokerage and Asset Management
Commercial and Investment Banks

- Steeper Yield Curve and Pro-Cyclical Loan Growth suggests HIGHER than GDP revenue growth for these mature, competitive industries
- Pro-Cyclical Merger & Acquisition Activity and Capital Origination Cycle also suggests HIGHER than GDP growth for these mature, competitive industries
- Lower Loan Loss Provisions and Credit Write-Offs could significantly ADD to bottom line profitability
- Portfolio Recommendation: Over-Weight
Life and Property Casualty Insurance

- Demographics, Pricing, and New Product Growth OFFSET by the Impact of Higher Interest Rates on Investment Portfolios (e.g. significant fixed-income portfolio)
- Net Combination of + versus - suggests approximate GDP type growth for these mature, competitive industries
- Portfolio Recommendation: Market Weight
Brokerage and Asset Management

• Brokerage (e.g. trading) and Asset Management Fees (e.g. fees X assets under management) OFFSET by Intense Price Pressures
• Expect Pro-Cyclical Growth to be OFFSET by Pricing Pressure which suggest approximate GDP growth rates for these mature, competitive industries
• Portfolio Recommendation: Market Weight
Regulatory Factors

Increased Total Loss-Absorbing Capacity (TLAC) Requirements could SUBTRACT from Profitability
- Financial Stability Board will set TLAC standards at 16% of risk-weighted assets by 2019 and increase the rate to 18% by 2022; Banks will need to add more senior debt, thus yielding an overall lower interest margin

Possible Dodd-Frank Rewrite Proposal in 2016 could ADD to Profitability
- Rewrite could potentially loosen regulatory cost to banks and other financial services providers; Support from Republicans, but not Democrats, suggesting than an Executive Branch political change would be needed

Regulatory Factors suggest Positives may OFFSET Negatives
Valuation Analysis
**Financial Sector vs. S&P 500 - Absolute Basis**

<table>
<thead>
<tr>
<th></th>
<th>High</th>
<th>Low</th>
<th>Median</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P/B</strong></td>
<td>S&amp;P 500 2.9818</td>
<td>Financial 2.0520</td>
<td>S&amp;P 500 1.6403</td>
<td>Financial 0.6001</td>
</tr>
<tr>
<td><strong>P/S</strong></td>
<td>S&amp;P 500 1.8647</td>
<td>Financial 2.5994</td>
<td>S&amp;P 500 0.7412</td>
<td>Financial 0.7382</td>
</tr>
</tbody>
</table>

**Financial Sector vs. S&P 500 - Relative (Current)**

<table>
<thead>
<tr>
<th></th>
<th>High</th>
<th>Low</th>
<th>Median</th>
<th>Current</th>
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</thead>
<tbody>
<tr>
<td><strong>P/E</strong></td>
<td>S&amp;P 500 51.4549</td>
<td>Financial 0.9846</td>
<td>S&amp;P 500 0.8463</td>
<td>Financial 0.7579</td>
</tr>
<tr>
<td><strong>P/B</strong></td>
<td>S&amp;P 500 0.6882</td>
<td>Financial 0.3658</td>
<td>S&amp;P 500 0.5130</td>
<td>Financial 0.4646</td>
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<tr>
<td><strong>P/S</strong></td>
<td>S&amp;P 500 1.3940</td>
<td>Financial 0.9960</td>
<td>S&amp;P 500 1.2846</td>
<td>Financial 1.1770</td>
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<tr>
<td><strong>P/EBITDA</strong></td>
<td>S&amp;P 500 0.8537</td>
<td>Financial 1.6486</td>
<td>S&amp;P 500 1.1698</td>
<td>Financial 0.7330</td>
</tr>
</tbody>
</table>

**Financial Sector vs. S&P 500 - Relative (Given)**

<table>
<thead>
<tr>
<th></th>
<th>High</th>
<th>Low</th>
<th>Median</th>
<th>Current</th>
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<tbody>
<tr>
<td><strong>P/E</strong></td>
<td>S&amp;P 500 74.2450</td>
<td>Financial 0.6867</td>
<td>S&amp;P 500 1.5815</td>
<td>Financial 0.7812</td>
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<td><strong>P/B</strong></td>
<td>S&amp;P 500 0.7498</td>
<td>Financial 0.3196</td>
<td>S&amp;P 500 0.5441</td>
<td>Financial 0.4783</td>
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<tr>
<td><strong>P/S</strong></td>
<td>S&amp;P 500 1.8478</td>
<td>Financial 0.6076</td>
<td>S&amp;P 500 1.3203</td>
<td>Financial 1.1993</td>
</tr>
<tr>
<td><strong>P/EBITDA</strong></td>
<td>S&amp;P 500 0.9378</td>
<td>Financial 0.7789</td>
<td>S&amp;P 500 0.8536</td>
<td>Financial 0.7789</td>
</tr>
</tbody>
</table>

- Observing the relative basis, the Financial Sector sits at a somewhat cheaper price than the S&P 500.
- The current multiples indicate the sector is falling below the 10-year trading median.
Financial Sector vs. S&P 500 Graphically

Financials vs. S&P 500 Graphs
SIM Portfolio Financial Sector

- Table shows the pessimism for the Financial Sector as Forward P/E show lower values.
- Overall AXP and WFC seems to track closer to the Financial Sector Index.

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Beta</th>
<th>Trailing P/E</th>
<th>Forward P/E</th>
<th>P/S</th>
<th>P/B</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Express Co.</td>
<td>AXP</td>
<td>1.19</td>
<td>12</td>
<td>10.8</td>
<td>1.91</td>
</tr>
<tr>
<td>Citigroup Inc.</td>
<td>C</td>
<td>1.64</td>
<td>8.01</td>
<td>7.7</td>
<td>1.86</td>
</tr>
<tr>
<td>KeyCorp.</td>
<td>KEY</td>
<td>1.05</td>
<td>10.82</td>
<td>8.31</td>
<td>2.35</td>
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<tr>
<td>Wells Fargo &amp; Co.</td>
<td>WFC</td>
<td>0.99</td>
<td>12.22</td>
<td>11.09</td>
<td>3.07</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>SPX</td>
<td>18.49</td>
<td>17.33</td>
<td>1.83</td>
<td>2.79</td>
</tr>
<tr>
<td>Financial Sector Index</td>
<td>SSFINL</td>
<td>14.7</td>
<td>13.5</td>
<td>2.15</td>
<td>1.29</td>
</tr>
</tbody>
</table>
Recommendations
Recommendations

• Arguments could be made to overweigh the sector relative to S&P 500
  • Remaining conservative, we recommend equally weighing the financial sector relative to the broader S&P 500 index

• Sector Weight Recommendations:
  • Commercial & Investment Banks: Over-Weight
  • Life & Property Casualty Insurance: Market-Weight
  • Brokerage & Asset Management: Market Weight
Opportunities & Risks to Recommendation

**Opportunities**

- U.S. housing market recovery
- Improved U.S. consumer financial strength

**Risks**

- Deflationary pressures
- Potentially increased volatility
Questions?