

White Paper

May, 2008

Financial Services Investing in 2008 – So What's To Love?

In these turbulent times, investors are looking for opportunities across different regions and different industries. Some believe that low price means undervalued and are looking for the best "bargains," the most battered companies, while others are waiting for the other shoe to drop and are sitting on the sidelines trying to time the market. Both approaches are incorrect. Investors need to look for the most promising long-term sectors regardless, and use the recent volatility to their favor. Yes, there are bargains out there, but for every bargain that is undervalued there are three that are a bargain for a reason. Smart investors must decipher between cheap and dying companies and undervalued gems – it is not easy to do.

I. Financial services overview and history

First, let's start with an industry. No industry has been hit harder by the recent market downturn than financial services. Deservingly or not, financial services companies have seen value destroyed, business models wrecked and a general panic across the industry. Does this mean financial services companies are going the way of buggy whip manufacturers? Of course not! The financial services industry is the largest industry in the world and central to the world economy. This recent turmoil gives smart investors the opportunity to gain exposure to one of the best performing industries.

And in financial services when investing fails – as it will a large proportion of the time – the result is almost never a complete loss. Unlike so many other high-potential sectors, financial services is very able to weather a downturn or survive a failed strategy. Some subsectors – portfolio management, wealth management, life insurance, business services, etc. – have such strong cash flows that you "cannot kill them with a stick" and investors rarely lose all they have invested. High cash margins cover a multitude of sins and protect the innocent and the guilty alike! On an individual company basis, strong financial services companies have historically outperformed companies in other industries. Between 1979 and 2007, seven of the ten best performing publicly traded stocks were financial services companies or had financial services exposure (See Exhibit I).

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Exhibit I. Top Performing US Stocks April 30, 1979 – October 31, 2007

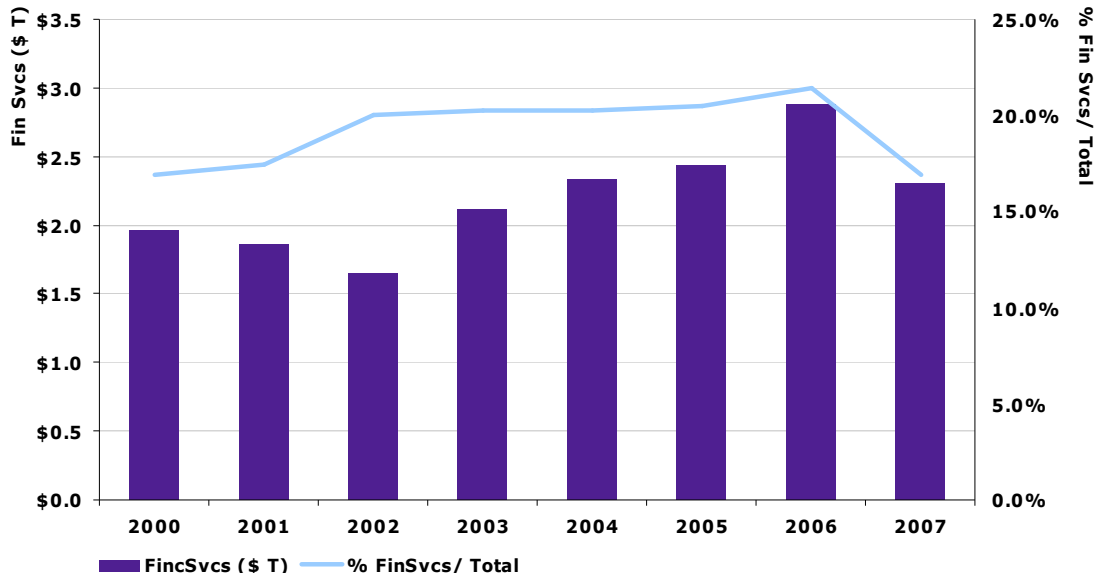
Rank	Symbol	Company	Annualized Total Return (%)	Sector
1	EV	Eaton Vance Corp.	31.74	Financials
2	LUK	Leucadia National Corp.	28.87	Diversified / Financials
3	CFC	Countrywide Financial Corp.	28.18	Financials
4	STT	State Street Corp.	26.48	Financials
5	BRK.A	Berkshire Hathaway Inc. (Class A)	25.83	Diversified / Financials
6	FRX	Forest Laboratories Inc.	25.70	Health Care
7	KSU	Kansas City Southern*	25.52	Industrials
8	WMT	Wal-Mart Stores Inc.	24.81	Consumer Staples
9	PGR	Progressive Corp.	24.74	Financials
10	PCP	Precision Castparts Corp.	24.65	Industrials

Source: FactSet

* KSU owned Janus and several financial companies until 2000

Historically, public investors have embraced financial services companies, whether it be for the financial stability of commercial banks, the predictable earnings of asset managers, or the explosive growth of financial technology companies. Since 2000, financial services share of the S&P 500 has ranged from 17% to 21%, and is clearly the largest sector in the index.

Exhibit II. S&P 500 – Financial Services



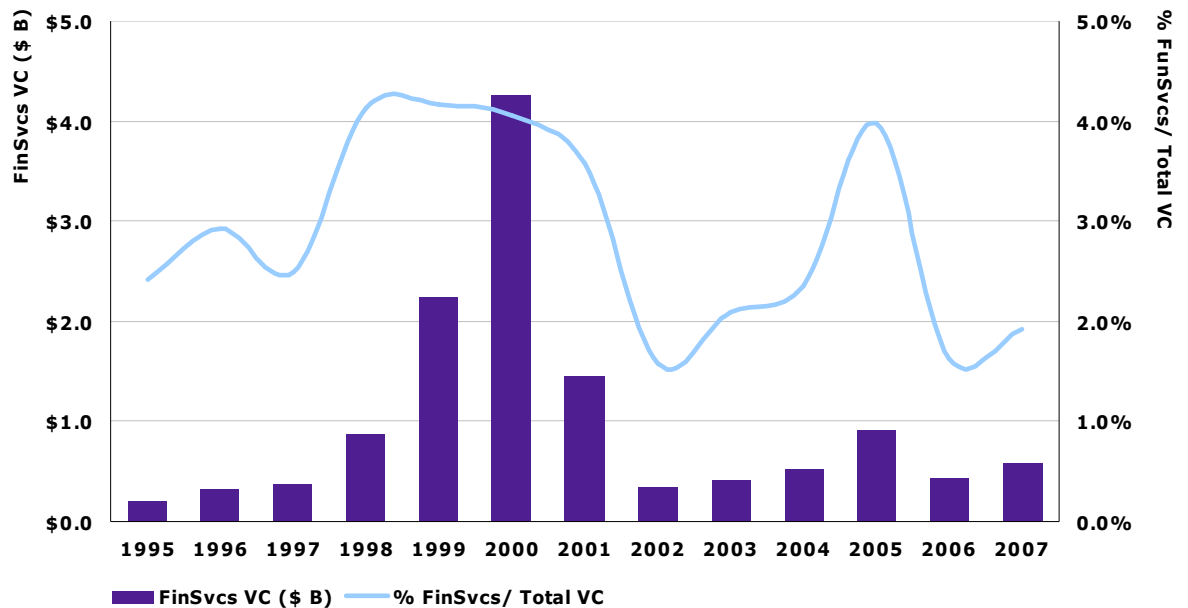
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On the private side, investors have been less aggressive in pursuing financial services companies. Many lack the expertise needed to navigate the personalities, the complex business model, the layers of regulation, and the lack of hard assets. The large buyout funds preferred models with hard assets they could lever to create financial returns. The VCs preferred to focus on the "homerun" type investing of technology and life sciences. As demonstrated below, the percentage of early stage private equity and VC money in financial services is below that of the public market, and well below financial services' share of GDP.

Exhibit III. Early Stage Private Equity and VC Activity



Source: PWC MoneyTree

The current market conditions have put certain large financial services companies in an interesting predicament. Their balance sheet exposure is such that they need to raise more capital. However, the credit crunch is preventing them from accessing more debt and most equity buyers are sitting on the sidelines. This gives management three choices 1) sell off assets, 2) sell the entire company, or 3) attempt to weather the storm. If they try to weather the storm, they put the entire firm at risk (could Bear Stearns have saved itself by selling off businesses in August?). Management teams did not get to the top without some sense of hubris, so it is likely they will consider all options before selling the entire company to a competitor. This leaves selling off businesses as the most likely option.

Buyers like motivated sellers – they tend to have lower price expectations and move quickly. These sellers are less concerned with price than they are with speed and certainty of close. This creates the perfect opportunity for well-financed, knowledgeable buyers. When the markets begin to turn around, these sellers will have access to more capital, which will give them longer runways, which will decrease their urgency to sell, which will lead to higher prices. Additionally, a turn in the market will see more people reentering from the sidelines.

With the current liquidity crisis, cash is no longer a commodity, and is, once again, king. The casual financial services investor is nervous about re-entering the market, and strategic acquirers are too bogged down with market and capital issues to consider acquisitions. With scarce capital

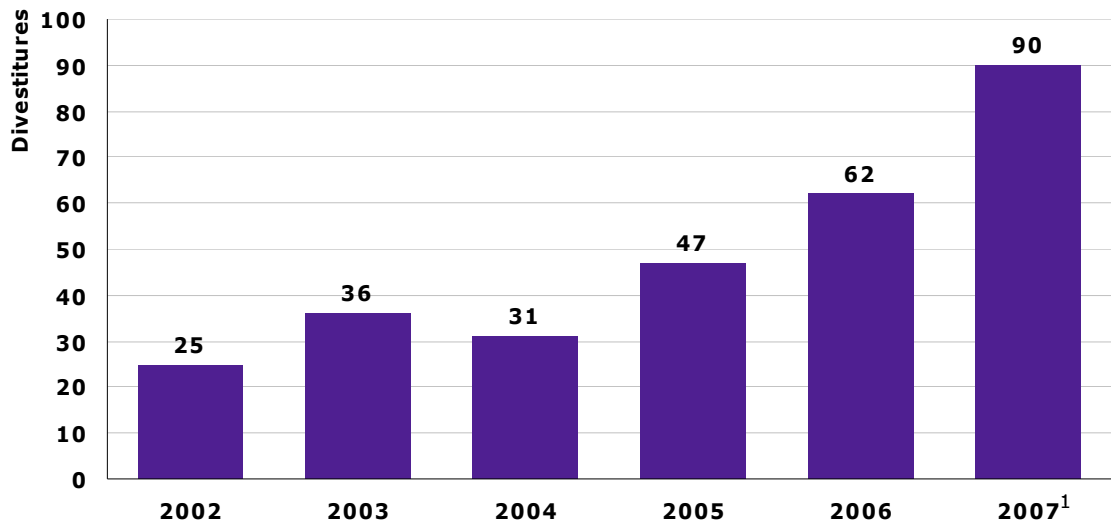
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and competition, valuations and valuation expectations are lower. And while strong firms may wait out the volatile environment, smart firms know that with additional capital they may take advantage of opportunities created by the turmoil. Additionally, many large companies who expanded into asset management, or other parts of financial services, are now retrenching to their core business and shedding non-core assets at reduced valuation. Smart, well financed investors have a wealth of opportunities to pursue (see Exhibit II).

Exhibit IV. Increase in Corporate Divestitures



¹ Annualized based on first 8 months of 2007

Source: SDC

Down times are great for private equity returns in financial services. In 2001 (-12%) and 2002 (-25%) investments in financial services private equity achieved IRRs approaching 30%, compared to a historical average of 18%. These are going to be good times for those who play the crisis correctly: in the sweet spot sectors that means investing with specialists who are seeking high-IRR, mid-range deals and who deal all over the cap table, including early stage and mezzanine.

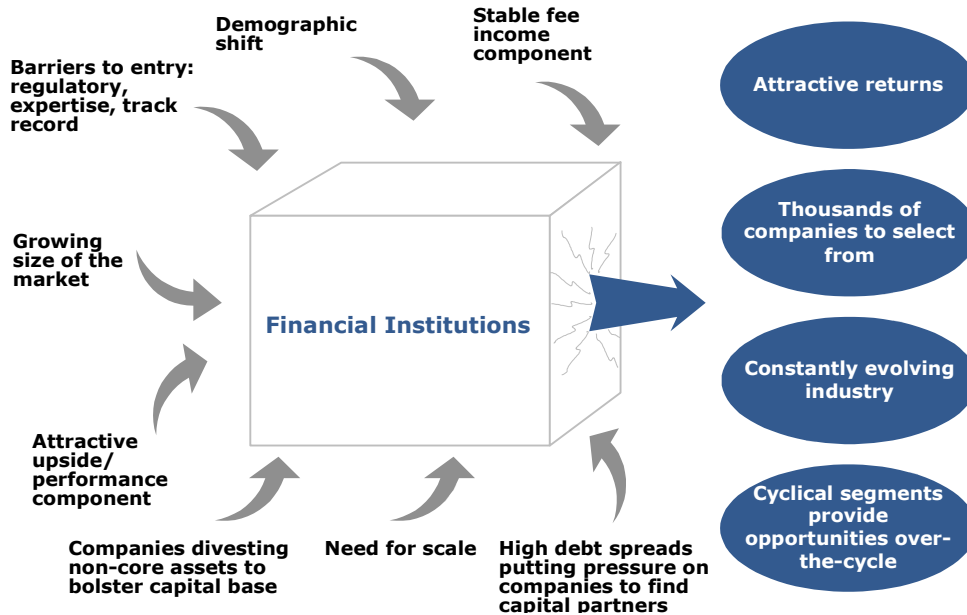
Of course, the next logical question is "Are we at the bottom of the market, or will it go lower?" The answer is IT DOES NOT MATTER. Very few stock pickers are able to get into a stock at the very bottom. What matters is buying something below its intrinsic value. We know that there are opportunities to buy well below intrinsic value right now.

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II. Why we love financial services



Source: Lazard

1. Demographics are the wind at our back, as are capital accumulations and conversions

More people with more money with more need to invest – in existing and emergent middle classes. While the total population of the planet will increase by about 1 billion people in the next 12 years, the ranks of the middle class will swell by as many as 1.8 billion. Of these new members of the middle class, 600 million will be in China. It is estimated that by 2020 the world's middle class will grow to include a staggering 52 percent of the global population, up from 30 percent now. The middle class will almost double in the poor countries where sustained economic growth is lifting people above the poverty line fast. For example, by 2025, China will have the world's largest middle class, while India's will be 10 times larger than it is today.

More commodity and agrarian assets converting to financial assets globally – at household, corporate and governmental levels. Witness the increase in profits at oil and mining firms and the spectacular rise in the price of stable agricultural products like corn, wheat and rice. Assets in sovereign wealth funds in emerging economies increased 24% in 2007 to \$3.5 trillion, driven primarily by increased sales of oil and gas.

2. Barriers to entry remain high, as do returns (go figure!)

The financial services have very high barriers to entry. For starters, it is a very complex industry. Many potential participants, and investors, are intimidated by this complexity. Second, it is highly regulated, thus keeping more potential entrants at bay. Finally, consumers do not make decisions based on price, but rather quality – they want the best for their money. Regulators, capital markets and consumer mythology combine to make it very difficult to create a financial services business from scratch or from an industrial base (Wal-Mart bank anyone?).

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Counter-intuitively, margins remain high – consumers see plenty of differentiation: Goldman's "magic," PIMCO's "insight," Wells Fargo's "discipline," Berkshire Hathaway's "homespun savvy," BGI's "quant methods", Fidelity's "continuous improvement", Farallon's "find-it edge", SAC's "contrary bet" and Blackstone's "relentless drive" are all tiny variations on a theme but they are enough to hold prices high and therefore enough to support margins. Perhaps it takes not genius but consistency (with occasional insight) to succeed for clients.

While industry complexity keeps investors out of the market, it creates better buying opportunities for seasoned investors. Experienced investors add more value to a financial services investment, and it is dramatic in the IRRs actually achieved.

3. Scale is incredible, which makes management the partners of capital

Proper business models create significant operating leverage – leverage that can add extraordinary value – but must be done in partnership with management. In asset management, for example, it costs the same for a team to manage \$100 million as it does for a team to manage \$2 billion. Every dollar of revenue generated after breakeven falls directly to the bottom line. That is what makes a successful platform so valuable: its ability to scale.

Traditional institutional investors struggle with the fact that the financial services industry is a people intensive business. Unlike manufacturing, transportation, media, and technology companies, financial services companies have limited hard assets on the balance sheet. This reduces the investor's downside protection (asset sale) and constrains the amount of financial leverage on the balance sheet. For people who are knowledgeable about the industry, this creates opportunity. While it is difficult to put high levels of debt on financial services companies, their low capital intensive business models create significant operating leverage – leverage that has the ability to add more value than capital leverage. This also reduces the risk that a company becomes over-levered. In fact only two asset management leveraged buyouts have ever defaulted on their debt obligations.

Compensation of leaders of these businesses confuses most observers we talked to (and this was before Merrill's latest hire!). If they deserve a million a week it is because scale benefits are so substantial – the product is literally free to transport and scarcity is a pricing metaphor – that those who can drive the top line and create effective partnership with upper management are worth their weight in, well, whatever.

4. It is big, growing and global on a US pattern

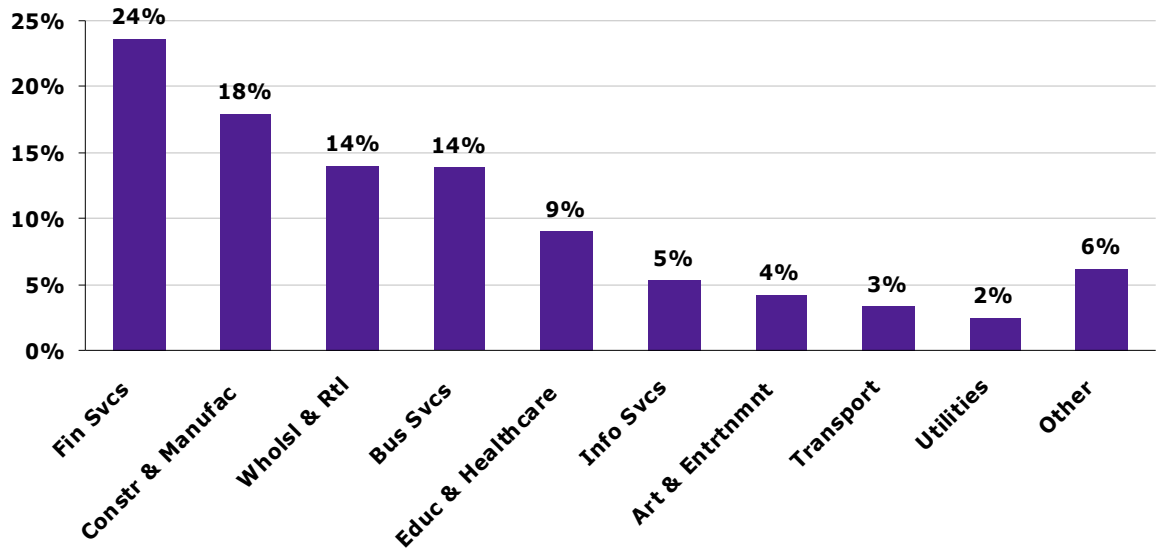
At 24% of US GDP, financial services is the largest US sector, with \$3 trillion in revenue, up three-fold from 1990 (See Exhibit V). It is at the center of the economy (every industry needs money to transact) and is vital to growth. As the world economy continues to expand and as new markets continue to develop, the need for financial services companies will only continue to increase. Aging populations in the US and Europe will continue to drive the asset management business; increased cross-border transactions will drive FX trading; robust Indian and Chinese economies will create opportunity for credit markets, insurance companies and asset management as the middle class grows in wealth and size.

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Exhibit V. US GDP by Industry - 2007



Source: US Bureau of Economic Analysis

The US financial services companies are world leaders, having exported capital market structure, economic theory and populist capitalism far better than the US has exported democracy, literacy, health care or separation of church and state. There is less concern that China or India will undercut US prices and force the industry overseas. The industry is not price driven, it is quality driven, and the US will be considered the gold standard in financial services for the foreseeable future. There are regional/local differences in how the world banks, trades and finances but convergence is well into its second decade. Global "best practices" are American methods, globally the product matrix is the US product matrix, and globally the language of performance is the Greek and the acronyms of US operators, analysts and investors.

5. It's fragmented, available and liquid

Financial services presents a variety of attractive sub-sectors and business plans. These sub-sectors have unique business models that are very attractive. With high barriers to entry (management sophistication, regulatory, etc.), the industries remains very fragmented. There are over 40,000 companies in financial services, almost 90% are profitable, with 30%+ posting margins in excess of their peers (love those scale effects!). There are powerful reasons why these companies transact, including the fact that many were formed ten to thirty years ago as private enterprises (globally, the average aggregate quarterly M&A deal value from 1979 to 2002 was \$102 billion in Financial Services vs. \$66 billion in High Tech, \$36 billion in Infrastructure/Construction/Transport/Utilities, \$43 billion in Population/Business Services and \$29 billion in Traditional Services)¹.

¹ Kara, Alper, Marques, David, Altunbas, Yener and Walkenhorst, Dominik, "Does the Financial Sector Drive Non-Financial Sector M&A Activity?" (August 24, 2007).

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Private equity firms have virtually ignored financial services, yet capital still flows from other investors. Public markets love the cash flows and margins of financial services. It is the largest component of the S&P 500 at 17% of market cap. Today, the S&P 500 is \$12.5 trillion with financial services companies at \$2.1 trillion, down from \$3.0 trillion just a year or so ago.

III. Where to focus

The secret to investing in financial services is to understand the industry, where it is going, and how to capitalize on the momentum of the industry. The industry is constantly changing (2-3 years is a lifetime in financial services). Among other trends, we are watching the following:

Increased specialization in financial services, accompanied by increased regulation and transparency, will be a death-knell for the “all things to all people” conglomerate.

As pension plans take an increasingly liability-aware, absolute-return approach to asset allocation to meet return assumption targets and preserve capital, asset managers are becoming increasingly specialized. The formation of niche specialists, new product development (Exchange Traded Funds (“ETFs”), universal managed accounts, private student loans), and increased demand for productivity tools and services is in turn resulting in an increase in spinouts and buyouts (at price advantage).

Increasing capital spent on enabling technology focused on efficiency and execution.

As certain industries grow and mature, companies need to improve operational efficiency to remain ahead of competitors. These operational improvements can very often be achieved through innovative and cutting edge technology. In an industry where small marginal improvements can be multiplied into real profits, technology will play a important role. Results: new enabling technologies and new financial products, crossing networks and analytics. New capital regulations will spur new products and niche reinsurance businesses.

A global retirement finance crisis.

Politicians, regulators and asset managers are being driven to change the current pension regime by a number of domestic and international imperatives. Demographic developments are well understood by those seeking elected office: by 2015 it is estimated that over fifty percent of US voters will be aged fifty and older, and pension security is vital to this growing constituency. The mismatch between assets and liabilities has led to the potential to upend the supply chain for defined benefit pensions and accelerate adoption of new products and broad solutions.

Segregation of Alpha and Beta.

With the continued evolution of Index Funds and the launch of ETFs, investors have been able to reduce the cost of Beta and separate it from performance metrics. Simultaneously, the rise of alternative asset classes has changed, and will continue to change, the fee structure of the industry. We see the growth of ETFs continuing as they become a core portfolio holding. They will be complemented by specialized alternative asset managers.

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Growing Regulatory Pressure.

The current market turmoil and “scandals” of the past decade have led to more government regulatory pressure. This regulatory pressure leads to more compliance and back office work which is often addressed by outsourcing and new technology. The clearest example of this is Sarbanes-Oxley, but the most recent crisis may lead to new and more complex regulations, especially in the mortgage and specialty lending sectors. We believe that the regulatory pressure will continue as the markets become more complex. This will lead to ample investment opportunity in outsourcing and financial technology.

IV. What to Do and What Not To Do

So where does one invest in financial services?

DO NOT INVEST IN US BANKS. US Banks are very dangerous in structural subjugation terms for equity. Outside the US the picture is better but the risks are higher, and local/regional factors are crucial. Although it goes against the general argument here, go with regional specialists rather than industry specialists (especially in the BRIC world).

DO NOT INVEST IN BROKER DEALERS. Broker dealers are unfinanceable (remember Refco?) and toxic when public. Stay clear. And yet be aware there are brokers who are not brokers but advisors (LPL).

DO NOT BUY PAPER ISSUED BY CLIENTS OF BANKS AND BROKERS. Buying the paper issued by clients of banks and brokers is a big opportunity – equivalent to Leon Black’s gains on high yield back in the day. But this train has left the station: over \$30 billion last year and the same amount so far this year. The average recovery time of the last three crises was just under two years. This time it may be shorter because the infrastructure for the fixed income world has grown very sophisticated – the explosive growth of asset-backed issues requires NASA-level analytics. At the same time the number of different ways to play has grown too. Bond or CDS? Onshore or off? Which issue, which layer? Maybe the converts or the preferred equity? How about a structured solution? How about a package of whole loans?

DO INVEST IN INSURANCE AND SPECIALTY FINANCE. These companies offer investors the opportunity to deploy a sizable amount of capital with very favorable risk/reward characteristics. Despite recent headlines to the contrary, these businesses have controllable risk. Certain sub-sectors such as credit cards and consumer loans offer protection through asset sales. These markets are usually more liquid and robust than the secondary markets in other industries (although we need the capital markets to unfreeze a bit!).

DO INVEST IN ASSET AND WEALTH MANAGEMENT. This is a huge, lucrative, underinvested sector. There are a dozen or more firms who falsely claim to have done deals.

DO BUY FINANCIALS, BUT QUIETLY, NOT PUBLICLY. Buying the bonds and equity of financials is a good idea if done quietly. But we are in for a long period of increasingly exaggerated swings of public pricing around long term value – you need to be ready to sell and watch the changing circumstances every day. We assert that the right way to buy is through the mandate of a specialist hedge manager.

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How does one identify an experienced manager, cutting through all the spin? In short: feed your alpha, not your ego – get the best managers on-side and let them work their magic.

DO NOT INVEST IN TEAMS WITHOUT SKIN IN THE GAME. If they do not have the majority of their personal wealth alongside your money – ignore percentages and get personal- they do not have the proper incentive. Ask about each layer of the firm.

DO NOT INVEST IN DEAL JUNKIES. Cross them off if they talk about negotiations instead of investing, deals instead of trends, financing instead of value, and the boardroom instead of the management.

DO INVEST IN EXPERIENCED TEAMS. If they have not done at least three deals with the same team in the subsector, they lack the proper experience.

DO INVEST IN TEAMS WITH A RANGE OF EXPERIENCE. If all personnel come from Wall Street and not industry, they lack the experience – these times demand real business knowledge and contacts, not slick financing.

So yes, we are in a crisis, yes we may be in the muck for another year. And yes, this is the time for financial services overweighting for experienced managers who have spent decades in Financial Services.