

## The Financial Sector and its Role in Market

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Over the last year we have witnessed unprecedented events that have affected every sector of equity. However, no sector has been affected quite like that of the financials. After seeing billions in bailouts, Lehman go bankrupt, and the unprecedented action by the Fed, the landscape of the financial sector has forever changed. Now that the dust is settling many are left wondering what is next for this key sector. While no one truly knows the answer to that question, one thing is for sure, proper capital allocation into this sector can be the difference between an outperforming portfolio and one that lags the market.

In September, when the S&P began its decent the financial sector led the way. Taxpayers sat and watched as Washington spent billions of their tax dollars to bailout Wall Street. Many began to question, and rightfully so, how giving billions of dollars to greedy executives with bad business models could really help the situation. Never the less the bailouts and government money continued to flow into the financial sector. Many of the largest financial institutions like Goldman Sachs, JP Morgan, and Morgan Stanley were actually made to take billions of dollars in order to shore capital and stabilize their balance sheets. These billions combined with a fed fund rate of basically zero have led to a wild and record breaking ten months for the financials. Investors sat by and watched the market lose 12 years of progress, led by the financials, and then, in the blink of an eye run up 50 percent. This has created a very unique situation for investors, both institutional and individual, and playing this volatility will be the key going forward.

One factor that has led to this unique environment is the fact that many institutional investors were in short positions when the market sank, and failed to reverse them at the bottom. When the S&P touched the 666 mark, a massive amount of money came off the sidelines and into the market. This drove the market higher, even though many institutions stayed short. This created large losses for these funds and in this ultra competitive environment portfolio managers cannot afford to fall behind. Feeling this pressure these large investors reversed and began a buying frenzy that drove the market up 50 percent in roughly 5 months. Not only was there a buying frenzy, some of it was forced due to the fact that many investors who played the market short were naked, or didn't own the underlying short. When this happens and the owner of the stock you sold wants to dump the stock, you are then forced to cover that short and buy the stock. This is called a short squeeze or a short cover and for the most part it drives the market higher. This combined with timed institutional investors unable to miss this rally created a perfect storm for the market. Although this unique situation contributed to the run up, it wasn't the only reason for the market's rebound.

Another large reason for the market's performance is because on a fundamental valuation bases, the market in general was undervalued. At its bottom the S&P had a dividend yield of over three percent while the two treasury yield was below one. Also the financial sector was trading at a multiple of around 7 when traditionally it can trade at over 20. Furthermore, with banks being able to borrow at near zero, net interest margins, which are the most key metric for financials, began to sore. This trend

reaches its height when Wells Fargo reported a net interest margin of 4.12 percent for the first quarter of 2009. They promptly gained roughly 30 percent and the rest of the financials followed suit, with all banks, including J. P. Morgan, Goldman Sachs, Morgan Stanley, and Bank of America. This began the market's rise from the bottom and it shows no sign of slowing down. Even in the face of rising unemployment, a supply-side saturated housing market, and weak GDP numbers from around the globe, the market continues to go higher. All of these things considered, we are all left with one question, is this a fundamental move higher or is it because of a massive short squeeze that has overheated the market and we are now due for a technical correction?

One metric to look at here is the short interest ratio or days to cover ratio. The short interest ratio is shares short over average daily trading volume. This basically gives an idea of the overall sentiment of a stock and gives an idea of what kind of buying pressure is present. When valuing a stock this must be taken into account. A stock with a high short interest ratio will likely face high buying pressure in the future as investors eventually close out their short position and get long. This should lead to a move higher, but as always, buyer beware because this move higher will more than likely not be based on fundamentals and therefore may very well not be sustainable. Since the market run-up the short interest ratio has come down 30 percent but is still not near the levels it was before the decline in September. This gives mixed feelings on the run-up and probably means that it has been both fundamental and a short squeeze. In the financial sector this ratio is incredibly important because financials are traditionally heavily shorted and typically trade with the most volume of any other sector. Therefore, keeping an eye on this ratio and trying to understand what it is saying will aid in playing the financials.

Another thing to watch when considering allocation into the financial sector is the recent volume decrease. Typically, lower daily volume, or shares traded per day, combined with a market that is going higher is not a good sign for the future, at least in terms of stabilization. Basically this thin market points to higher volatility in the future and could be very tricky for the average investor. One way to track this is to keep an eye on the volatility index, ticker symbol  $VIX$ . If this rises be careful because a volatile market is a trader's market which is dangerous for the average investor.

Finally we come to the question, what is the best way to play the financials? There is never one answer to this type of question and as always picking stocks is an art not a science. The best strategy, however, for the average investor is to remain a buy and hold strategy but remembering to keep an eye on key metrics. Pick individual stocks with stable dividends, and good growth opportunities in emerging markets, and good leadership. Do not be fooled by hot stocks with bad fundamentals and no short interest. Where possible buy protection to the downside by purchasing puts. This will protect you in the case of high volatility. Never be scared to sell part or all of a stock and take profits off the table because the stock may go higher. When an equity you own reaches a level you set get out, take your profits, and look elsewhere. Most importantly remember that diversification will see you through any bear market. While the financials should probably be an overweight going forward (roughly 19 percent of your overall portfolio) every sector should be represented in some capacity and that allocation should be rotated depending on overall market outlook. In order to beat the market and consistently grow your wealth, use a combination of a passive and active strategy, keep a close eye on key metrics, and

remember warren buffets old saying of “When others are greedy be cautious, and when others are cautious be greedy.”