

## ***Shift from Fear to Fundamentals- Significant Implications***

### **July 2009- Market Outlook**

In the wake of better-than-expected bank results so far this quarter (quality issues aside), next in line are 2Q results for insurance companies. Results have not been reported, but certain insurance stock valuations have already benefitted from the favorable impact of banks that showed an increase in tangible common equity ratios. The reason bank results helped improve insurance stock valuations is simple: right or wrong, investor perception of banks drives valuations – up and down – across the entire financial sector.

**Yes, Stunning:** The capital data in last week's bank results marks a stunning turning point. The improved tangible common equity ratios are a quantifiable sign that financial stocks march to the edge has not only halted, but reversed direction. The increase in tangible common equity is not a 2<sup>nd</sup> derivative change, such as a slowdown in a negative trend, and is not an improvement rooted in sentiment. Tangible common equity is a fundamental, quantifiable measure, and the prior deterioration weighed heavy on valuations across the entire financial sector. "Apocalypse Not", the title of our last write-up, and our outlook at the time, appears to be taking shape for some of the reasons we've previously highlighted.

**From Fear to Fundamentals:** Our call in the spring was that valuations would shift away from fear and back towards fundamentals. The shift should have a significant, upside impact on stock prices. Consider P/B values. With no change in current ROEs, certain stocks have historically traded at 140% - 150% of book value based on fundamentals, yet fear has pushed the valuations of these stocks below book value. This is opportunity.

**When:** A sure sign that fundamentals have re-gained a place in the valuation process is the emergence of the picky investor. Not all revenue growth is equal quality, but the market appeared perfectly happy to boost stock prices when certain banks merely beat revenue expectations. Little was said about one-off contributions to these results: trading revenue, sale of subsidiaries, etc. Our take is that investors passed over the revenue details, and reacted more to the improved capital positions. All revenue growth appears good right now, but as investors get picky it's a sign fundamentals have started to return to valuation.

**Interesting Comparison:** Insurance companies do not have the banks' exposure to consumer credit or provisions, but investor attention will certainly focus on two other challenges faced by insurance companies: investments, and premium pricing trends. We expect our portfolio of insurance stocks will fare well by these two measures. In fact, our portfolio's slight weighting towards reinsurance stocks should play out well over the next several quarters. We have gravitated towards companies with a focus on lines of business that appear well positioned to benefit from rate increases, and benefit from the capital constraints at other companies.

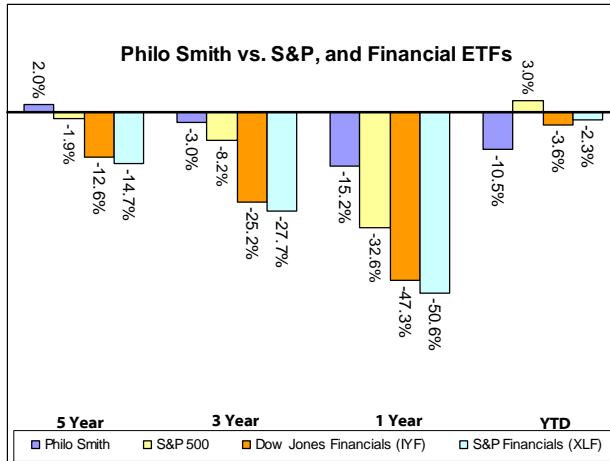
If you have questions regarding the financial services sector, or would like to discuss our investment approach, please contact us at 203 348-7365.

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# Performance

Year-over-year through May 30th, 2009



Year-over-year through June 30th, 2009

