

INTRODUCTION

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FINANCIALS BASICS

Trends within the Financials sector are often topics of heated debate, and for good reason—not only is it the largest sector in most broad equity indexes globally, but it revolves around one of the things most hold very dear: money. Money is transferred, multiplied, protected and placed at risk in the Financials sector. The sector is considered the lifeblood of the global economy—and while a properly working Financials sector can be a boon, its going haywire can have unfortunate consequences.

Many of this sector's products and services are relatively simple, like making a cash deposit at a bank or using a charge card for your morning cup of coffee. And many are quite complex, like making a leveraged bet in a synthetic collateralized debt obligation. Financial innovation has transformed the sector from its simple roots into an incredibly complex system—so complex that, at times, it can engender great fear.

Globally, governments are well aware of the complexity and importance of the Financials sector, making it one of the world's most highly regulated sectors. From central banks to financial services authorities to consumer protection agencies—the government's hand in the

Financials sector is a core concern, capable of promoting prosperity or driving disaster in the sector and economy as a whole.

This book's intention is not to provide detailed instruction on complex financial structures' construction, focus on the 2008 financial panic (as many other books attempt to do) or discuss in detail the impact of myriad proposed and existing regulations, but rather to help readers make better decisions about when to over- or underweight the sector (or the industry positioning within) as part of an overall portfolio strategy. Moreover, we attempt to demystify many of the sector's complexities and allow for a better understanding of trends. The aim is not to provide definitive answers, but to help readers learn to think critically about this and, indeed, any other sector.

Global Versus Domestic

In our view, a global approach to investing is superior to a domestic-only approach because it allows for greater diversification and more opportunity. However, for data availability, consistency and reliability reasons, we often use domestic data to demonstrate a point. Most often, we refer to the S&P 500 for domestic trends and either the MSCI World or MSCI All Country World Index (ACWI) for global trends. The S&P 500 is an index of the largest US firms, the MSCI World represents the largest developed world firms and the MSCI ACWI also includes Emerging Markets.

FINANCIALS 101

The Financials sector is quite a bit more diverse than many who are new to analysis might assume. However, at a very high level, there are some overarching defining characteristics. First and foremost, it is, as of this writing, the world's largest sector. In addition, the sector tends to be:

- A relatively more volatile sector that tracks closely with broader markets
- More “value” oriented than “growth”

- Neither big nor small
- Sensitive to interest rates
- Not cyclical, yet not defensive
- Heavily regulated
- Highly leveraged and reliant on other people's money (OPM)

The Largest Sector

The Financials sector is the largest in most global and country-specific benchmarks simply because it represents more companies with more assets, income, equity and sales than any other sector.

Balance Sheets In terms of assets and shareholder equity—two main components of any company's balance sheet—the Financials sector accounts for \$89 trillion in assets and nearly \$7 trillion in equity.¹ That's 72% of assets of all firms in the MSCI All Country World Index and 32% of all shareholder equity (see Table 1.1).² Simply put, the Financials sector dwarfs all others.

Definitions: Assets and Shareholder Equity

Assets are items of economic value that can be converted to cash, like equipment, securities or real estate. To many financial companies, loans or securities tied to loans are core assets.

Shareholder equity, also known as net worth, is equal to assets minus liabilities.

Income Statements Using the income statement to value a company is a common technique. Often, a company will be valued based on a multiple of its total sales or net income. When it comes to Financials sector firms, both measurements are often used. Each illustrates the sector's size, but to a lesser degree than assets or equity (as shown in Table 1.2).

Comparing the balance sheets and income statements of companies within the broad market, the Financials sector's large weight

Table 1.1 Percent of Assets and Shareholder Equity by Sector

MSCI ACWI Sector	Assets	Equity
Financials	72%	32%
Industrials	5%	9%
Consumer Discretionary	4%	9%
Energy	4%	14%
Utilities	3%	6%
Materials	3%	8%
Telecommunication Services	2%	6%
Consumer Staples	2%	6%
Information Technology	2%	6%
Health Care	2%	5%

Source: Thomson Reuters; MSCI, Inc.,³ as of 12/31/2010.

Table 1.2 Percent of Aggregate Sales and Net Income by Sector (2004–2010)

MSCI ACWI Sector	Sales	Income
Financials	17%	22%
Energy	16%	16%
Industrials	13%	10%
Materials	13%	10%
Consumer Staples	11%	8%
Consumer Discretionary	7%	8%
Health Care	6%	8%
Information Technology	6%	7%
Telecommunication Services	6%	6%
Utilities	5%	5%

Source: Thomson Reuters; MSCI, Inc.,⁴ as of 12/31/2010.

seems reasonable. In fact, with the sector accounting for 22% of net income and 32% of equity, it is easy to understand why the Financials sector plays such a prominent role in most broad equity market indexes.⁵

Financials Sector Weight

Thanks to financial innovation, increased credit penetration and growing acceptance of debt, the Financials sector has more than doubled its weight in the S&P 500 over the last 20 years (see Table 1.3). This trend illustrates the US economy's transition from an industrial economy to a more information- or knowledge-based economy. But it's not just in the US. Globally, knowledge-based sectors like Technology and Financials have grown, while Industrial and Manufacturing sectors have shrunk. The difference is more pronounced in developed economies since many emerging economies remain more dependent on raw materials and manufacturing.

A More Volatile Sector

The Financials sector tends to be more volatile on average than others yet also tracks closely with broader markets. From 12/31/1974 to 12/31/2011 (a period for which we have good sector data), the Financials sector returned a 9.6% annualized average compared to the S&P 500's 11.5%.⁶

Don't take that to mean Financials is a below-average sector. No—all well-constructed categories of stocks should yield similar returns over very long time periods. There's no fundamental reason one category should be any better or worse than any other—though they will all go through periods of leading or lagging. For example, from 12/31/1974 to

Table 1.3 Financial S&P 500 Weights Since 1990

S&P 500	1990	1995	2010	2011
Financials Weight in Index	7.1%	12.7%	16.5%	14.3%
Banks	40%	53%	42%	35%
Real Estate Investment & Services	0%	0%	0%	1%
Real Estate Investment Trusts	1%	0%	8%	13%
Life Insurance	8%	5%	7%	7%
Nonlife Insurance	31%	20%	16%	18%
Financial Services (Sector)	21%	21%	26%	27%

Source: Thomson Reuters; ICB Classifications; S&P 500 Index from 12/31/1990 to 12/31/2011.

12/31/2007 (before 2008’s financial crisis), the sector was in line with the S&P 500. Its poorer relative average return now is due to the pretty steep Financials sector-led bear market in the late 2000s.

A relative return index is an easy way to plot the trend of two data series’ relative performance over time. In Figure 1.1, the gray line represents the value of the S&P 500 Financials index divided by the value of the S&P 500 index, while the arrows show general directional trends. As the Financials index outperforms the S&P 500 index, the line moves higher, and vice versa.

Most major stints of relative under- or outperformance have been *event driven*—meaning some major, largely unanticipated event shocked the system some way and changed the sector’s relative trajectory. (Again, see Figure 1.1.) After fairly in-line performance from the 1970s to mid-1980s, the sector underperformed through the early 1990s as the Savings & Loan (S&L) crisis (as well as multiple sector-specific issues) weighed on it. Outperformance from the early 1990s to the late 1990s was tied to attractive valuations, innovation and a generally

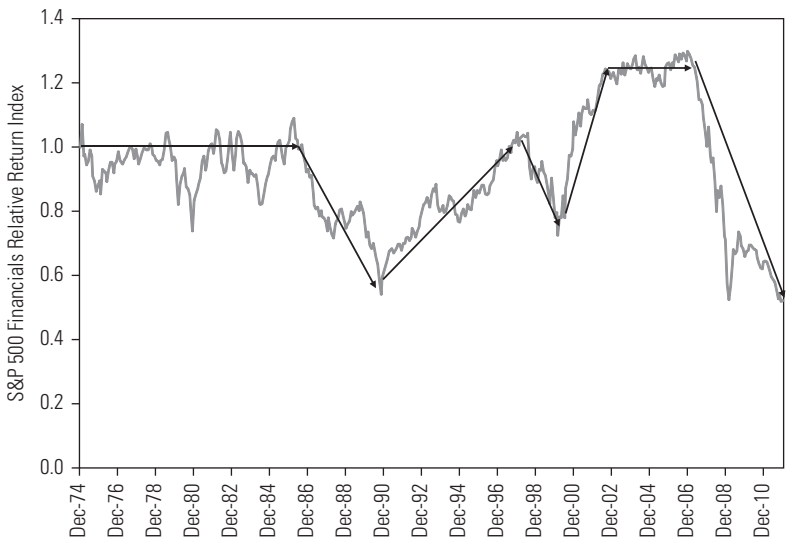


Figure 1.1 S&P 500 Financials Sector Relative Return Index

Source: Global Financial Data, Inc.; S&P 500 Financials Sector versus S&P 500 Index from 12/31/2004 to 12/31/2011.

stable economic environment. Long Term Capital Management, the Asian Contagion and the tech/Internet boom drove Financials sector underperformance into 2000—until the “new economy” blew up and Financials performed well since the sector was relatively insulated from the Internet debacle. Investors moved to value investing, and real estate trends buoyed bank credit quality. In the late 2000s, however, the sector vastly underperformed tied to increased losses from souring mortgage loans, which intensified as a financial panic arose.

Globally, the trend is similar except for a stark difference during the late 1980s and early 1990s: While US Financials was plagued with domestic issues such as the S&L crisis and bad oil sector loans, foreign Financials was not. As a result, foreign Financials outperformed during the late 1980s. Conversely, as domestic Financials recovered in the early 1990s, foreign Financials was pressured as US financial companies re-emerged on the global scene and competition increased. Trends between US and foreign Financials in the 1970s, early 1980s and from the mid-1990s to early 2000s are similar, but since foreign Financials did not suffer through the late 1980s, it has outperformed domestic Financials since 1974.

While sector returns over long periods of time are similar, each sector does vary in its return volatility. One common measure of volatility is *standard deviation*.

Standard Deviation

Standard deviation measures the historic deviation from average returns over time. The higher the standard deviation, the higher the swings in returns during any given time period.

There are three levels of deviation. A one-standard deviation event demonstrates events within a 64.2% probability band. A two-standard deviation event demonstrates events outside the 64.2% probability band. A three-standard deviation event is something that doesn't happen 99.6% of the time. When given the standard deviation of returns, this number typically illustrates a one-standard deviation event—meaning if the sector's standard deviation is 23.3% returns will vary from 23.3% above to 23.3% below its average return over time with a 64.2% probability.

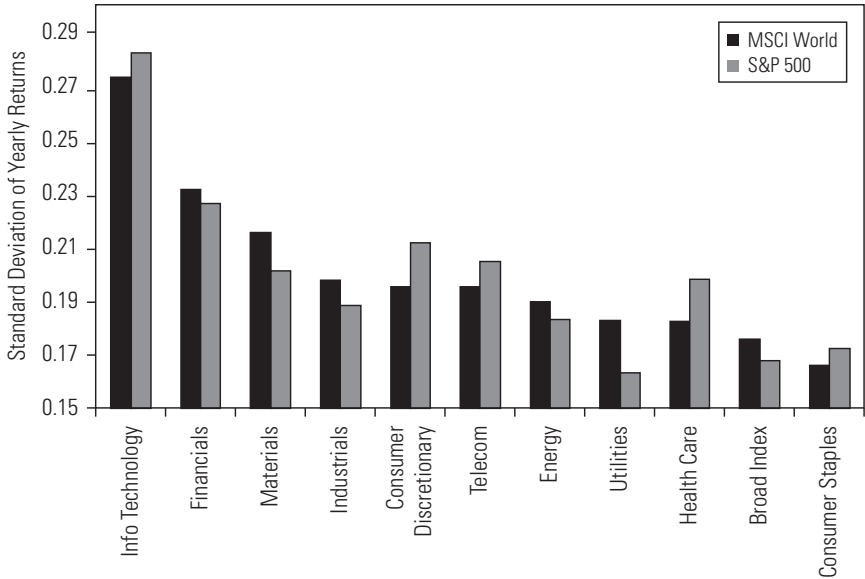


Figure 1.2 MSCI World and S&P 500 Sector Standard Deviation of Yearly Returns

Source: Global Financial Data, Inc.; Thomson Reuters; MSCI World Sector Indexes and S&P 500 Sector Indexes, Rolling 12-Month Returns from 12/31/1974 to 12/31/2011.

The Financials sector globally and domestically has the second highest standard deviation of returns over time, just behind the Information Technology sector (see Figure 1.2). Even stripping out the unusually high volatility associated with 2008’s financial panic and the subsequent sovereign debt crisis, Financials still remains the second most volatile sector by this measure.

So, Financials is typically more volatile than the market average—but that doesn’t mean it widely deviates from the broad market direction. Remember, a rising tide lifts most boats. When broad markets rise, so do Financials—usually. And when markets fall, so do Financials—most of the time. However, because of Financials’ exposure to capital markets–related functions—like asset management, brokerage and investment banking—and its high leverage, which amplifies gains and losses, it tends to be sensitive to overall market trends (i.e., it has a relatively high *beta*).

Beta, Correlation and R-Squared

Beta is a measurement of how responsive a financial asset is to the market as a whole. An asset with a beta of 1.1 is expected to perform roughly 10% better than the market in a rising market and 10% worse in a falling market.

Correlation is a statistical measure of how two securities move in relation to each other. The measurement, or coefficient, ranges between 1 and -1 , with 1 being a perfectly positive relationship and -1 being perfectly negative. R-squared is calculated by squaring the correlation coefficient and represents the explanatory relationship between two securities. In other words, when compared to the S&P 500, a stock with a correlation coefficient of 0.80 would have an R-squared of 0.64, which means 64% of its movement can be generally explained by the S&P 500's movement.

The S&P 500 Financials sector has a beta of 1.10, and the MSCI World Financials Index has a beta of 1.18, relative to the respective broad market indexes, since 1974.⁷ This makes it the highest beta sector globally and third highest domestically. (See Table 1.4.) Typically, a higher historical beta is indicative of a sector that is more economically sensitive over time—sectors like Technology, Financials and Consumer Discretionary fit the bill. A beta greater than 1 tells us the sector typically goes up more than the market in up markets and

Table 1.4 Sector Beta

	MSCI World	S&P 500
Financials	1.18	1.10
Information Technology	1.13	1.35
Industrials	1.05	1.04
Consumer Discretionary	1.03	1.11
Telecom	0.80	0.86
Utilities	0.79	0.62
Health Care	0.76	0.85
Energy	0.72	0.71
Consumer Staples	0.69	0.67

Source: Global Financial Data, Inc.; Thomson Reuters from 12/31/1974 to 12/31/2011.

down more in down markets—but this relationship is not static, as you can see in Figure 1.3.

The Financials sector is also highly correlated to the broader market. (See Table 1.5.) This is not so surprising since at 20% to 30%

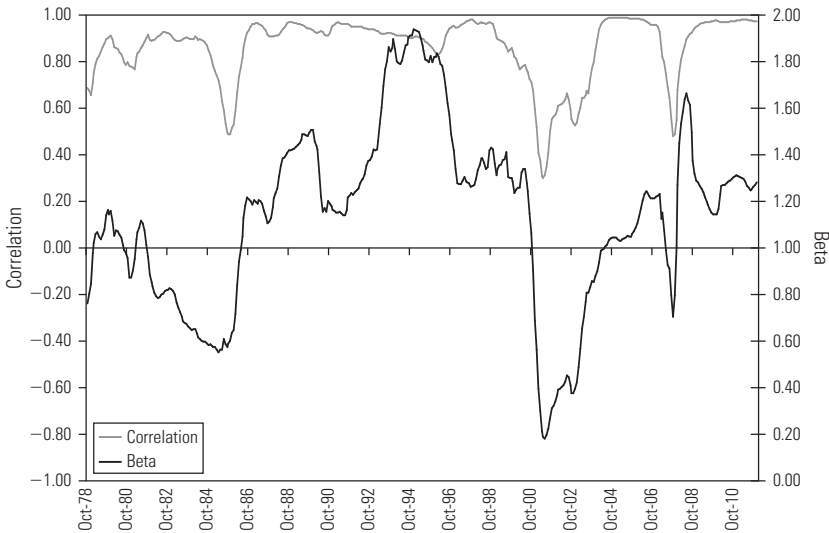


Figure 1.3 Financials Sector's Correlation and Beta

Source: Global Financial Data, Inc., 36-month rolling correlation and beta from 12/31/1947 to 12/31/2011.

Table 1.5 Sector Correlation

	MSCI World	S&P 500
Industrials	0.93	0.92
Consumer Discretionary	0.93	0.87
Financials	0.90	0.82
Materials	0.83	0.77
Utilities	0.76	0.64
Consumer Staples	0.73	0.65
Health Care	0.73	0.72
Information Technology	0.73	0.80
Telecom	0.72	0.71
Energy	0.67	0.65

Source: Global Financial Data, Inc.; Thomson Reuters, as of 12/31/2010.

of most broad market indexes, it contributes a large portion to broad market returns.

As with other sectors, the Financials sector beta and broader market correlation ebb and flow over time. Sometimes, like during the 2008 credit panic, the sector's beta is higher than normal. And other times, like the early 2000s Technology-led bear market, beta was lower as Financials considerably outperformed in an overall falling market. The correlation of the sector is usually highly positive, but again, it varies over time, just like the other sectors. Figure 1.3 shows Financials correlation and beta to the S&P 500 rising and falling over time.

More "Value" Than "Growth"

Financials firms tend to be more value oriented than growth. Table 1.6 shows the composition (by sector market cap) of common growth or value indexes. Financials is much more prevalent in the value index. Additionally, when looking at how much of each sector is considered value (by market cap), only Utilities and Telecom are more

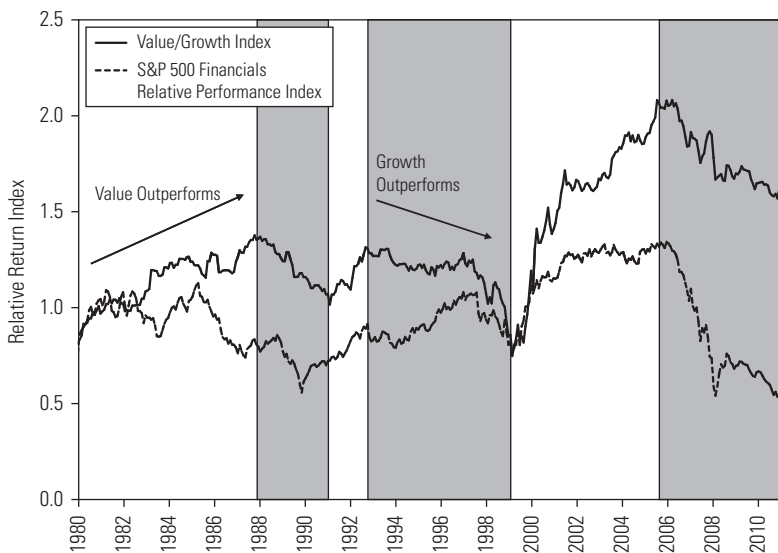


Figure 1.4 Growth Versus Value Cycles and Financials Relative Performance

Source: Thomson Reuters; Russell 3000 Index from 01/31/1979 to 12/31/2011.

Table 1.6 Sector Weights in Growth and Value Indexes

MSCI AC Sector	Value	Growth
Financials	30%	9%
Energy	15%	8%
Health Care	10%	8%
Industrials	8%	13%
Telecommunication Services	7%	2%
Materials	6%	9%
Consumer Discretionary	6%	15%
Utilities	6%	1%
Consumer Staples	6%	15%
Information Technology	5%	20%

Source: Thomson Reuters, as of 12/31/2011.

value-centric. Conversely (and not surprisingly), Tech is the most growth-oriented sector. As a result of Financials’ value-ish nature, the sector has a 30% weight in the MSCI ACWI Value index but just 9% in the Growth index.⁸

What Is Value? And What Is Growth?

Firms deemed to have a relatively low price compared to some metric or set of metrics such as cash flow or book value, or those that have low earnings growth or high dividend yields, are usually called “value” firms—i.e., they’re a good value for the price.

Firms positioned opposite to value firms, such as those with high earnings growth and perhaps low dividends, are considered “growth.” The idea is investors are willing to pay a higher price in anticipation of those metrics growing—earnings rocketing up, the enterprise growing in value, etc.

Some investors prefer value stocks, while others favor growth. Over long periods, neither group has very different performance, and neither is inherently superior to the other.

Like all major categories, value and growth trade leadership in irregular cycles. From 1979 to 2005, there were four distinct growth

cycles and three prolonged value cycles, with many shorter cycles within the longer cycles. Since Financials is more value than growth, Financials typically underperforms during growth cycles and outperforms during value cycles. Figure 1.4 shows periods when growth (gray area) or value (white area) is generally outperforming the broader market. Note how Financials' relative performance tends to act similarly to, though not exactly like, the value/growth index.

Highly Leveraged

More than firms in any other sector, Financials firms tend to be highly *leveraged*—meaning they have a lot of liabilities on their books relative to equity. (See Table 1.7.) A simple way to measure leverage is to examine a basic assets-to-equity ratio (assets/equity). Because its firms are so leveraged, changes in asset values have a much larger impact on the Financials sector than on any other.

Table 1.7 Leverage Ratio by Sector (MSCI AC World Sectors)

	Leverage Ratio
Financials	13.8
<i>Banks</i>	17.0
<i>Insurance</i>	11.5
<i>Real Estate</i>	2.4
<i>Diversified Financials</i>	12.9
Industrials	3.5
Utilities	3.4
Consumer Discretionary	3.0
Telecommunication Services	2.6
Consumer Staples	2.5
Materials	2.2
Health Care	2.2
Information Technology	2.1
Energy	2.0

Source: Thomson Reuters; MSCI, Inc.,⁹ as of 12/31/2011.

Among Financials sector sub-industries, Banks are the most leveraged based on a basic assets/equity ratio. However, bank leverage is wildly complex, and though a basic leverage ratio can be used for simple comparison purposes, it does not show the whole picture. Many other types of leverage ratios are utilized in the group, which can lower the stated leverage if asset values are altered by risk-weighting certain assets or accounting for collateral. (More on this in Chapter 2.)

Interest Rate Sensitivity

All sectors are sensitive to interest rate trends in some way. However, since Financials firms are, by definition, heavily exposed to financial assets and are typically leveraged to boot, interest rate trends tend to be more important.

From 1990 to 2010, Financials sector income growth had an R-squared of 0.62 to the 10-year US Treasury bond yield, while collectively, non-Financials sectors had an R-squared of 0.40. Additionally, relative to the US Federal Funds Target Rate (short-term interest rate) over the same period, the Financials sector's income growth had a 0.31 R-squared versus 0.10 in non-Financials sectors.¹⁰

In the stock market, the 10-year yield has a similar impact—most of the time. Since 1970, the Financials sector's relative performance has been highly negatively correlated to the 10-year yield except during certain stressed periods—the credit panic, recession and recovery of the late 2000s, the Asian Contagion in the late 1990s and the extraordinarily high interest rates of the early 1980s. (See Figure 1.5.)

Companies within the Financials sector are impacted by interest rates in many ways. Since interest rates simply represent the cost of borrowing, higher interest rates make borrowing more expensive, while lower interest rates make borrowing cheaper and promote loan growth. Insurance companies prefer higher interest rates so their investment portfolios earn more interest income. Real estate companies find higher interest rates troublesome because they can pressure real estate portfolio values, while investment banks and brokers prefer higher rates to capture higher spreads.

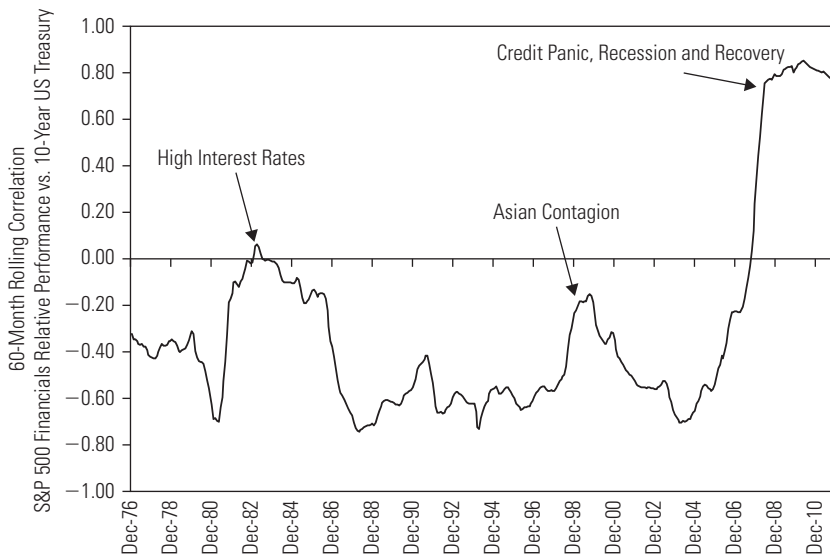


Figure 1.5 Correlation of Financials Sector Relative Performance and Interest Rates

Source: Global Financial Data, Inc.; S&P 500 Financials and S&P 500 Indexes; Federal Reserve 10-Year US Treasury Yield from December 1975 to December 2011.

Since the sector is dominated by lenders, trends therein drive the sector's relationship with interest rates for the most part, and Financials stocks tend to do a bit better when interest rates are falling as investors anticipate greater profits from greater volumes. Conversely, Financials stocks tend to underperform in rising interest rate environments. (We will go into more detail on how interest rates impact the various industries in subsequent chapters.)

Since 1970, there have been 10 distinct periods of rising interest rates (see Table 1.8). US Financials underperformed in all but four, with average annual underperformance (relative to the S&P 500) of -2.9% .¹¹ Falling interest rates are typically less bad for Financials over time—Financials underperform by -0.4% ¹² which isn't immaterial, but much of the underperformance can be attributed to poor relative performance leading up to and following the 2008 financial panic. Nothing is absolute in investing—Financials can outperform in a

Table 1.8 Financials Relative Performance and Interest Rates

Rising 10-Year Interest Rates

Begin	End	S&P 500 Financials	S&P 500	Relative	Change in 10y Yield (bps)
12/31/1970	9/30/1975	−1%	8%	−8%	198
12/31/1976	9/30/1981	38%	37%	1%	903
5/31/1983	6/30/1984	−22%	−1%	−21%	303
1/31/1987	10/31/1987	−19%	−6%	−13%	170
10/31/1993	11/30/1994	−6%	0%	−6%	248
1/31/1996	4/30/1997	44%	29%	15%	112
10/31/1998	1/31/2000	10%	29%	−19%	204
6/30/2003	6/30/2006	42%	38%	4%	161
12/31/2008	4/30/2010	32%	35%	−3%	144
10/31/2010	2/28/2011	16%	13%	3%	96
	Average	13%	18%	−5%	
	Average Annualized Return (ARR)	5%	8%	−2.9%	

Falling 10-Year Interest Rates

Begin	End	S&P 500 Financials	S&P 500	Relative	Change in 10y Yield (bps)
9/30/1975	12/31/1976	48%	34%	13%	−167
9/30/1981	5/31/1983	60%	53%	8%	−503
6/30/1984	1/31/1987	118%	97%	21%	−666
10/31/1987	10/31/1993	137%	127%	11%	−345
11/30/1994	1/31/1996	64%	44%	20%	−231
4/30/1997	10/31/1998	35%	40%	−5%	−208
1/31/2000	6/30/2003	13%	−27%	40%	−314
6/30/2006	12/31/2008	−58%	−25%	−33%	−290
4/30/2010	10/31/2010	−10%	1%	−10%	−106
2/28/2011	12/31/2011	−22%	−4%	−18%	−170
	Average	39%	34%	5%	
	ARR	11%	11%	−0.4%	

Source: Global Financial Data, Inc., from 12/31/1970 to 12/31/2011.

rising or falling interest rate environment. And, with underperformance in only 6 out of 10 periods, we can say interest rate trends are important, but many other factors also impact the sector over time.

Definition: Duration

Interest rates clearly impact the Financials sector, but they have a varying impact on assets and liabilities, depending in part on duration. Duration measures the time required to recover a dollar of price in present value terms. To fixed-income investors, such as most companies in the Financials sector, duration represents a security's interest rate sensitivity. Typically, a higher-duration security will be more sensitive to changes in interest rates.

Not Cyclical, Yet Not Defensive

Most sectors tend to favor either bull or bear markets more markedly, but the history for Financials is mixed. In that sense, Financials can't be clearly labeled as either cyclical (i.e., does better in a bull) or defensive (i.e., does better in a bear), despite the sector's cyclical underpinnings.

For many other sectors, getting a broad market call right can go a long way toward knowing whether a sector will perform reasonably well—but that may not work for Financials. Over longer periods, Financials' relative performance in both bulls and bears works out to be similar (see Tables 1.9 and 1.10, which show bull and bear markets since 1972 and relative Financials performance), but that similar relative performance comes with some major deviations. For example, Financials strongly outperformed during the great 1990s bull market. The 1990s bull market followed extreme stresses in the previous decade that were driven by geographical and sector-specific issues: Mutual savings banks in the Northeast, S&Ls nationally, agricultural banks in the Midwest, oil patch banks in the Southwest and real estate loans in coastal states—all of these hammered Financials. As these issues passed, the Financials sector was attractively valued

Table 1.9 S&P 500 Financials Versus S&P 500 Composite in Bull Markets

Bull Markets				
Begin	End	S&P 500 Financials	S&P 500	Relative
9/30/1974	11/30/1980	116%	195%	-79%
8/31/1982	8/31/1987	192%	237%	-45%
12/31/1987	7/31/1990	41%	58%	-17%
10/31/1990	3/31/2000	792%	515%	277%
10/31/2002	10/31/2007	69%	92%	-22%
3/31/2009	12/31/2011	53%	67%	-14%
	Average	211%	194%	17%
	ARR	17%	18%	-1.2%

Source: Global Financial Data, Inc.; S&P 500 Indexes, from 12/31/1971 to 12/31/2011.

Table 1.10 S&P 500 Financials Versus S&P 500 Composite in Bear Markets

Bear Markets				
Begin	End	S&P 500 Financials	S&P 500	Relative
12/31/1972	9/30/1974	-46%	-43%	-3%
11/30/1980	8/31/1982	17%	-7%	24%
8/31/1987	12/31/1987	-30%	-24%	-6%
7/31/1990	10/31/1990	-29%	-14%	-15%
3/31/2000	10/31/2002	-3%	-39%	36%
10/31/2007	3/31/2009	-72%	-47%	-26%
	Average	-27%	-29%	2%
	ARR	-26%	-24%	-2.8%

Source: Global Financial Data, Inc.; S&P 500 Indexes, from 12/31/1971 to 12/31/2011.

and ripe to take advantage of a growing economy, falling interest rates and stable inflation.

Then, Financials badly lagged in a 2007–2009 bear market caused primarily by issues specific to the Financials sector. Essentially, Financials' performance and market cycles do not go hand in hand, and unless you can forecast an exception—perhaps a banking crisis—it is best not to allow the market cycle to dictate your relative Financials weighting.

When it comes to economic cycles, it is a similar story—getting a broad macroeconomic call correct likely won't be enough to reliably predict forward-looking Financials outperformance. During the seven economic expansions since 1970 (see Tables 1.11 and 1.12), Financials underperformed four times. However, average annualized performance overall through the expansions was just shy of the S&P

Table 1.11 Financials Sector Relative Performance During Economic Expansions

Economic Expansion				
Begin	End	S&P 500 Financials	S&P 500	Relative
12/31/70	11/30/73	33%	14%	20%
03/31/75	01/31/80	58%	71%	−13%
07/31/80	07/31/81	20%	13%	7%
11/30/82	07/31/90	116%	243%	−128%
03/31/91	03/31/01	531%	285%	247%
11/30/01	12/31/07	31%	44%	−13%
06/30/09	12/31/2011	13%	44%	−31%
	Average	115%	102%	13%
	ARR	11.9%	12.4%	−0.5%

Source: Global Financial Data, Inc.; National Bureau of Economic Research; S&P 500 Indexes Total Return from 1970 to 2011.

Table 1.12 Financials Sector Relative Performance During Economic Recessions

Economic Recession				
Begin	End	S&P 500 Financials	S&P 500	Relative
11/30/73	03/31/75	−21%	−8%	−13%
01/31/80	07/31/80	6%	9%	−4%
07/31/81	11/30/82	28%	14%	14%
07/31/90	03/31/91	11%	8%	3%
03/31/01	11/30/01	−1%	−1%	0%
12/31/07	06/30/09	−57%	−35%	−22%
	Average	−6%	−2%	−4%
	ARR	−11%	−4%	−7.0%

Source: Global Financial Data, Inc.; National Bureau of Economic Research; S&P 500 Indexes Total Return from 1970 to 2011.

500 because return dispersion was material in a few periods. Of note, Financials greatly underperformed during the long 1980s expansion, thanks in no small part to the S&L crisis. Then, Financials vastly outperformed in the 1990s expansion.

During economic recessions, the sector underperforms on average, but absent the dislocations in the 2007–2009 period, performance about matches the broader market. As with market cycles, these data illustrate relative performance is often driven by one-off events like a financial panic or crisis.

Heavily Regulated

Because the financial system is the backbone of most economies, Financials is one of the (if not the) most highly regulated sectors in the world. Understanding how the sector is regulated and why are key to making better forward-looking forecasts. (We cover regulation in more depth in Chapters 2 through 5.)

Financials core regulators/overseers include:

- Committee of European Banking Supervisors
- Bank for International Settlements (Basel)
- Global central banks (US Federal Reserve, European Central Bank, Bank of Japan, Bank of England, etc.)
- Financial services authorities (FSA, ASIC, CSSF, AMF, etc.)
- Consumer Financial Protection Bureau
- Federal Deposit Insurance Corporation
- Comptroller of the Currency
- Securities and Exchange Commission
- State bank and insurance regulators

Decisions made by these (and similar) entities can greatly impact the sector. Whether tightening consumer protections (which could reduce profitability) or mandating higher capitalization levels (which could cause a painful round of dilution), regulators impact investors. However, changes are inevitable, and investors can't much control future regulation—so investors shouldn't dwell on “bad” regulation.

And wishing regulation were implemented differently is mostly fruitless. Rather, investors should attempt to decipher regulation and how new or existing rules likely impact Financials stocks' future profitability. Also, regulation often punishes some at the benefit of others—what's known as “regulatory arbitrage”—so correctly determining the likely winners and positioning portfolios accordingly can add relative value.

Reliant on Other People's Money (OPM)

The Financials sector is unique among most other sectors because a major driver is trends within capital markets. What's good for capital markets is usually good for Financials firms. For example, is the aggregate economy increasing its borrowing? Do investors have more assets to be saved, managed, hedged, brokered or exchanged? Are higher asset values driving increased need for insurance? Are higher real estate values allowing for higher rents? These questions need to be answered when considering positioning within the Financials sector, and we will discuss these further as they relate to the various industry groups in subsequent chapters.

FINANCIALS SECTOR BREAKDOWN

The Financials sector is fairly diverse, so understanding its industry groups and sub-industries is important to overall sector analysis. A useful way to understand how the sector breaks down is looking at the industry-standard GICS.

Global Industry Classification Standards (GICS)

The Global Industry Classification Standard (GICS) is a widely accepted framework for classifying companies into groups based on similarities. The GICS structure consists of 10 sectors, 24 industry groups, 68 industries and 154 sub-industries. This structure offers four levels of hierarchy:

- Sector
- Industry group

- Industry
- Sub-industry

According to GICS, the Financials sector consists of 4 industry groups, 8 industries and 26 sub-industries. The sector is one of the broadest with the most representative companies in the GICS framework, and it contains the second largest number of sub-industries, trailing the Consumer Discretionary sector. Following are the industry groups and corresponding industries for the sector.

Industry Group: Banks

- Commercial Banks
- Thrifts & Mortgage Finance

Industry Group: Diversified Financials

- Diversified Financial Services
- Consumer Finance
- Capital Markets

Industry Group: Insurance

- Insurance

Industry Group: Real Estate

- Real Estate Investment Trusts (REITs)
- Real Estate Management & Development

Chapters 2, 3, 4 and 5 delve deeper into the industry groups, but before moving on, it's important to understand what the Financials sector looks like globally, how it fits into a broader benchmark and how its industries fit into a broader Financials benchmark.

Global Financials Benchmarks

First, what's a benchmark? What does it do, and why is it necessary? Simply, a benchmark is your guide for building a stock portfolio.

It's a point of reference—a standard for measurement and evaluation and the investor's road map for building a stock portfolio. You can use any well-constructed index—like the MSCI World or S&P 500, for example—as a benchmark. This is just as true for a sector as it is for the broader stock market. And by studying the index's composition, you can assign expected risk and return to make underweight and overweight decisions for each category. (We'll talk more about benchmarks in Chapter 6.)

So what does the Financials investment universe look like? It depends on the benchmark. Table 1.13 shows 5 float-adjusted (i.e., excluding shares held by the government) market capitalization-weighted equity indexes, with the weight of each of the 10 market sectors. The MSCI World includes only developed countries and the EAFE only developed foreign countries. The MSCI EM and the S&P 500 are specific to Emerging Markets and the US, respectively, while the Russell 2000 is a small-capitalization US index.

Table 1.13 Equities Benchmark Comparison

	MSCI World	MSCI EAFE	MSCI EM	S&P 500 Composite	Russell 2000
Consumer	10%	10%	8%	11%	13%
Discretionary					
Consumer Staples	11%	12%	8%	12%	4%
Energy	12%	9%	14%	12%	7%
Financials	18%	21%	24%	13%	21%
Health Care	11%	10%	1%	12%	12%
Industrials	11%	12%	6%	11%	15%
Information	12%	5%	13%	19%	17%
Technology					
Materials	7%	10%	13%	4%	4%
Telecommunication	4%	6%	9%	3%	1%
Services					
Utilities	4%	5%	4%	4%	3%

Source: Thomson Reuters; MSCI, Inc.,¹³ as of 12/31/2011.

Besides being the largest sector in most broad indexes, the Financials sector is also the largest sector in 19 of the 45 countries in the MSCI ACWI. Table 1.14 shows the Financials weight within each country in the MSCI ACWI. Generally, the larger the weight a sector is in a country, the more important it is to the country’s economy. For example, Financials’ health is highly important to countries like Hong

**Table 1.14 Weight of Financials
in Country**

MSCI AC World Index	
Hong Kong	61%
Turkey	49%
Singapore	46%
Morocco	45%
Australia	44%
Poland	43%
Austria	42%
Colombia	42%
Spain	41%
Egypt	40%
Hungary	37%
China	36%
Peru	35%
Thailand	35%
Philippines	35%
Greece	33%
Canada	32%
Malaysia	31%
Italy	31%
Indonesia	30%
India	26%
South Africa	26%
Sweden	25%
Brazil	25%
Czech Republic	24%
Netherlands	19%

Table 1.14 Weight of Financials in Country (Continued)

Switzerland	18%
UK	18%
Japan	18%
Chile	17%
Germany	17%
Russia	15%
Taiwan	15%
Finland	15%
France	15%
Belgium	14%
Norway	14%
Korea	14%
US	14%
Israel	14%
Denmark	11%
Portugal	8%
Mexico	7%
Ireland	0%

Source: Thomson Reuters; MSCI, Inc.,¹⁵ as of 12/31/2011.

Kong, Turkey, Singapore and Morocco, where the sector accounts for 45% or more of their market capitalizations.¹⁴

Fixed Income Benchmarks

The Financials sector accounts for substantially more assets than any other sector in the world, but it also accounts for more liabilities than any other sector. In 2011, the MSCI ACWI Financials sector had \$95 trillion in liabilities. This is over four times the amount of all the other sectors' liabilities combined.¹⁶ A large component of these liabilities is publicly traded debt instruments—bonds.

The global bond market's estimated value in 2011 was \$98.7 trillion (\$34 trillion domestic, \$65 trillion foreign).¹⁷ This market's scope and scale make it challenging to completely dissect, but the Bank of America Merrill Lynch Global Broad Market Index does a pretty good job (see Table 1.15). This index attempts to mimic the performance of

**Table 1.15 Bank of America Merrill Lynch
Global Broad Market Index Weights**

Sector	Weight
Sovereign	54%
Securitized/Collateralized	17%
Quasi & Foreign Government	12%
Corporate—Total	17%
Corporate—Financials	7%
Banking	6%
Financial Services	1%
Insurance	1%
Corporate—Industrials	8%
Automotive	0%
Basic Industry	1%
Capital Goods	1%
Consumer Cyclical	1%
Consumer Non-Cyclical	1%
Energy	2%
Health Care	1%
Media	0%
Real Estate	0%
Services	1%
Technology & Electronics	0%
Telecommunications	1%
Corporate—Utility	2%

Source: Bank of America Merrill Lynch, as of 12/31/2011.

publicly issued investment-grade debt in major bond markets globally and is a widely used fixed income benchmark.

Unlike equity indexes, corporate bond indexes are typically grouped into three sectors rather than the 10 GICS sectors: Financials, Industrials and Utilities. When measured this way, the Financials component of the corporate bond market accounts for 44%, Industrials for 45% and Utilities for 11%.

However, when rearranged into GICS sectors, the Financials sector's dominance in the corporate bond market is clear. It accounts for

Table 1.16 Industry Group Weights Within Financial Sector Indexes

	MSCI World	MSCI EAFE	MSCI EM	S&P 500 Composite	Russell 2000
Banks	7.3%	11.3%	17.2%	2.7%	7.1%
Diversified Financials	4.0%	2.9%	2.4%	5.3%	3.1%
Insurance	3.8%	4.3%	2.6%	3.6%	3.0%
Real Estate	2.6%	3.0%	1.6%	1.9%	8.2%
Financials Sector	17.6%	21.4%	23.8%	13.4%	21.4%

Source: Thomson Reuters; MSCI, Inc.,¹⁹ as of 12/31/2011.

41% of investment grade corporate bonds—nearly four times the size of the next-largest sector (Utilities).¹⁸

Being the largest sector in the bond market means nothing in itself, but it further illustrates the sector's scale. It also highlights how sensitive the sector is to trends in the bond market. Bonds are simply another way companies raise capital—the more leveraged a company is, the more impactful trends in debt markets are.

Sector Benchmarks

Sectors, just like the broader market, have their own benchmarks, and each industry constitutes a portion of the overall Financials benchmark. Also like the broader market, investors can overweight and underweight different categories based on their expected risk and return characteristics. Table 1.16 illustrates the Financials sector industry group weights in five main benchmarks.

Banks are typically the largest industry group in the Financials sector, but in the US, weights are impacted by banks that are not banks (see Chapter 2) and by the US-centric and small nature of REITs (see Chapter 5).

