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Financials... There have Been Some Safer Harbors

We, like many market participants have been on alert to watch for signs of a bottoming in the financial group. After their bout of significant underperformance and the heaps of fiscal and monetary stimuli directed towards them there is a risk of being overly bearish. However, within our portfolios we have remained underweight the sector and have yet to see the signal that would indicate a bottom is in place. A few of the discouraging signs include:

- 1. Earnings Estimates continue to fall:** One of the signs that things are getting better is when analyst estimates have become overly pessimistic and downward revisions get ahead of company guidance. While estimates have dropped considerably, companies continue to deliver news worse than even the most pessimistic projections.
- 2. Low Confidence in estimates:** Earnings estimates are always reliant on a heavy dose of conjecture, however lately they have become increasingly so in this arena. Loan-loss reserving, the degree of marks companies are applying to the securities held on their balance sheets and a number of other areas are not only growing in importance with regard to their impact on the financial statements, they are also becoming increasingly less transparent and more subjective.
- 3. Calvary Called back in:** A great deal of monetary stimulus has been applied already to aid the banks, however with inflation fears rising and commodity prices skyrocketing, the probability of additional rate cuts which has been a key driver in bank stock performance recently, has disappeared.
- 4. Market Message:** The leadership the financial group began showing after the January 08 rate cuts and the Bear Stearns bail-out has dissipated. The financial group has reverted to its trend of lagging on up-days for the market and leading the market lower on down-days. This is a signal that the buyers are disappearing, and remaining holders of financial stocks lack the conviction to maintain their holdings in the face of bad news.

What to do:

While reluctant to overweight financials, the group still comprises over 15% of the S&P 500 and investors need to own a few names in their portfolio no matter the level of bearishness or uncertainty. For those seeking exposure, we think there are a few rules of thumb to apply in the selection process that should help steer portfolios clear of the major wreckage:

- Rule 1:** The bigger and more diversified the financial institution, the more difficult it is to value. While the CEOs of the major financial firms may preach diversification and large balance sheets, these attributes, in our opinion, only lessen clarity in difficult economic times.
- Rule 2:** Hide in the center, avoid the coasts. Real estate valuations got most ahead of themselves on the coasts of the U.S. and less crazy in the interior cities and suburbs. The interior also benefits from the fact that two of the best performing industries: energy and agriculture are more prominent.
- Rule 3:** Listen to the market. When things are uncertain, we tend to place greater value on the aggregate opinion of the market through technical analysis. When a financial company makes a new low, like American International Group (AIG-N-\$39.04), the market is sending a strong signal to beware.

A few names that screen well based on our three rules include:

- Property & Casualty/Specialty Insurers:** Aflac (AFL-N-\$66.23)
- Pure Play Investment Banks:** Goldman Sachs (GS-N-\$191.00)
- Regional Banks:** Cullen Frost (CFR-N-\$57.49), US Bank (USB-N-\$34.25)

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