MOI GLOBAL

Select Portfolio Investments: Financials

This article[1] is excerpted from a letter by MOI Global instructor Phil Ordway, Managing Principal at Anabatic Investment Partners, based in Chicago, Illinois.

Our lone community bank investment as of this writing is **OceanFirst (OCFC)**.[2] We did not buy or sell any shares of OCFC during 2019 and we still hold a meaningful investment. OCFC's shares returned 17% in 2019, lagging both the broader equity markets and an index of its banking peers. Any disappointment should be tempered by the fact that the company improved its profitability and competitive position during the year.

Despite an uncertain macro environment that seems to get all the attention, OCFC is plowing ahead with its profitable, efficient operation. Credit quality is excellent (non-performers were just 0.3% of total assets in the most recent quarter) and OceanFirst is more than willing to turn away business if it does not meet stringent credit standards. Net income is running close to 1.2% to 1.3% on assets and 14% to 15% on tangible common equity, and the company's efficiency ratio is in the low-50% range, a level on par with the best community banks in the country.

In December 2019 the company announced an authorization to repurchase up to 5% of its outstanding shares. The most encouraging part of the announcement was this statement: "The Company believes the repurchase of shares remains a good long-term investment opportunity due to the current market prices of the common stock; general market and economic conditions affecting the Company, the Bank and the banking industry in general; and the other alternatives available for investment by the Company."[3] Again, that simple logic would be unremarkable if it weren't so rare among corporate stock repurchase decisions.

OceanFirst also completed two more acquisitions: Two River Bancorp, a community bank in New Jersey with just over $1 billion in assets, and Country Bank Holding Company, a somewhat smaller lender to small businesses and individuals in metro New York City.[4] The prices paid by OceanFirst were reasonable, if not mouth-watering, and both deals were cultivated over many years with an investing mindset.

These acquisitions, which closed on January 1, 2020, take OceanFirst just below the important regulatory threshold of $10 billion in assets. The company has a strategy to manage the important upcoming phase of growth and I remain impressed with management's performance. Ongoing vigilance is required for any signs of deterioration in credit standards, the culture, or management's decision making. When the inevitable downturn happens, OceanFirst's stable, low-cost deposits and conservative lending culture will help it emerge stronger on the other side.

Shares of the **Charles Schwab Corp. (SCHW)** were the only new investment made in 2019. Schwab is a business I have long admired, and a brief window in October offered the chance to invest at prices I viewed as attractive. I've followed the company for years and grown to appreciate its powerful combination of culture and strategy: Schwab puts the client first and keeps costs as low as possible. That may sound trite, but it's easier said than done. Schwab's multi-decade track record of success also proves that its mottoes are more than just words.

The engine of economic advancement is fueled by removing waste and improving efficiency. Many – perhaps most – of the best businesses in the world are engaged in an endless battle for lower costs that can be passed through as lower prices for customers. Schwab shares this ethos with many other historical standouts such as Costco and Southwest. Recessions, natural disasters, macroeconomic headwinds, and competitive skirmishes all come and go, but companies that meet this high bar find more opportunity than danger when downturns arrive.

The industry landscape is also important in this analysis, and individual cost structures within an industry are critical. The world is a competitive place, and low costs usually win. Schwab is in good shape in this regard. Its recent expense ratio as a share of average client assets was 16 basis points; Ameritrade and E*TRADE were at 27 and 37 basis points, respectively, while Merrill Lynch and Morgan Stanley were at or above 50.[5] Schwab has always been intentional about building its business around low costs, and once in place that is a hard advantage for any competitor to replicate.

Schwab's low prices, growing product breadth, and well-regarded customer service have enabled significant growth. In just the last 10 years Schwab leapt from 4th place to 1st among peers as assets grew from $1.4 trillion to $3.8 trillion.[6]

3rd Quarter 2009	SCHW	JPM	BAC	MS	WFC	AMTD + ETFC
Client assets ($ trillions)	$1.4	$1.7	$1.9	$1.5	$1.2	$0.5
Rank	*4th*	*2nd*	*1st*	*3rd*	*5th*	*6th*

3rd Quarter 2019	SCHW	JPM	BAC	MS	WFC	AMTD + ETFC
Client assets ($ trillions)	$3.8	$3.1	$2.9	$2.6	$1.9	$1.9
Rank	*1st*	*2nd*	*3rd*	*4th*	*5th*	*6th*

The factors driving this growth and these market share shifts appear likely to continue in the next 10 years. Customers want low-cost, tech-enabled, personalized offerings. Financial advice is increasingly episodic, fee-based, and independent. Traditional "wirehouses" and asset management firms are losing share to other platforms, many of which combine human and "robo" features, conflict-free advice, and passive/index funds (often via ultra-cheap ETFs). Schwab is positioned well for these trends.

Despite many business successes in the past decade it has not been an easy environment in many ways. Almost two-thirds of Schwab's revenue is now derived from a spread earned on clients' cash, and low interest rates have been a persistent headwind. As some areas such as proprietary ETFs have grown, other areas such as retail trading volumes and commissions have been in secular decline.

Things came to a head on October 1st when Schwab's share price plunged 10% to a multi-year low after it announced that all equity trading commissions would be eliminated.[7] This result was inevitable based on market trends and Schwab's own decades-long push in that direction. Lower commission rates were the founding inspiration of the company, and Schwab had reduced its commission rates many times over the preceding decades. Many of Schwab's critics even admitted that the company was making a smart move, one that was more a question of "when" than "if." By acting first Schwab further entrenched its leadership position in the industry and forced its competitors to respond.

The equity market had a somewhat different opinion. Schwab's one-day stock price decline of 10% erased more than $5 billion of market value and appeared to be an overreaction. Management estimated a reduction to annual revenue of $400 million or less – 3% to 4% of total net revenue – due to the elimination of trading commissions, but industry trends made it clear long ago that most of the earnings stream from commissions would be gone sooner or later.[8] Assets were continuing to migrate to Schwab's platforms and profits were healthy, but 2019's reversal in interest rates combined with this perceived escalation of a "price war" soured the market's appetite.[9] It was a classic case of short-sightedness that was corrected within weeks.

In late November Schwab announced its plan to acquire rival TD Ameritrade. This deal had been a possibility for years, but the timing was somewhat of a surprise coming so quickly after the commission cuts. Schwab had already recovered all of its early-October market price declines before the deal was announced – solid 3rd quarter results helped – but the deal drove the market's opinion even higher.

The acquisition makes plenty of sense for both sides. The combined company would have about $5.1 trillion in client assets, giving it plenty of scale to better compete with Fidelity (a behemoth at almost $8 trillion in client assets) and others. Schwab + Ameritrade would be a clear leader in the independent RIA business with a strong position in retail brokerage and advisory, low-cost ETFs, savings and banking products, trading/execution, and customer service.

Schwab is using all stock in the ~$26 billion acquisition, and the terms look reasonable so long as the combined company delivers a healthy performance. But mergers are never easy. There are some antitrust concerns that will need to be addressed, and the integration will be tricky given the vast scope of each platform (especially on the IT side).[10] The two cultures shouldn't repel each other, but there is also a partial headquarters relocation to manage. The promise of this deal is enormous and I think the chances of a favorable result are on the company's side, but getting there won't be easy. The other risks in owning Schwab include sustained lower interest rates, a sustained decline in capital-markets activity, cybersecurity, and a general decline in customer service and company culture.

Now for the not-so-great news. I committed just less than 5% of our capital to an investment in Schwab shares over four days in October at an average cost of less than $37 per share. Unfortunately, the price began climbing right away and I didn't act quickly – or smartly – enough to buy more shares. There is always the chance of further price declines and hindsight is always 20/20, but at a price in that general range Schwab shares were promising enough to warrant at least 8-10% of our capital. For now we will have to be content with approximately 6% of our portfolio invested in Schwab.

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We did not buy or sell shares in **Ambac (AMBC)** in 2019 as they appreciated more than 25%. (For background on our longstanding Ambac investment please refer to prior letters.)

I wrote at this time last year that "2019 will likely see the end of our Ambac investment," and I'm sorry to report that I was too optimistic yet again. The new wasn't all bad, however. An appellate court in the Countrywide litigation ruled mostly in Ambac's favor and eliminated a bench trial in favor of a jury trial for the primary claims. It took seemingly forever, but a trial date was finally set – barring a postponement or settlement, the four-week trial is scheduled to commence on July 13, 2020. Ambac has also made improvements to its balance sheet that should eventually benefit shareholders.

Our investment stands at approximately 3% of capital as of this writing. I'm looking forward to writing the post-mortem on this idea…*hopefully* in our next letter.

[1] This is section is used to discuss investments – both good and bad – that have had a material impact on our recent results or have the potential to do so in the future; it is not meant to be a comprehensive portfolio review. Please note that discussion of any positions currently being bought or sold, or any that may be difficult to buy or sell in the future, will be omitted.
[2] The two community bank investments sold during 2019 were small and did not make a material contribution to results.
[3] https://www.snl.com/IRW/file/102614/Index?KeyFile=401727245
[4] https://www.snl.com/IRW/file/102614/Index?KeyFile=399128255
[5] Fiscal years ended December 2018. Fidelity's costs are not reported on this basis, but there is no evidence that Fidelity has a material cost advantage over Schwab. Source: https://bit.ly/2tSeuuC
[6] Source: https://bit.ly/2QXcbzv
[7] A $0.65 fee per options contract remains. Source: FactSet and https://bit.ly/2NoyqvY
[8] Ameritrade and E*TRADE were more dependent on trading commissions and their stock prices declined 26% and 16% that day, respectively. Source: FactSet, SEC filings, and https://www.aboutschwab.com/cfo-commentary
[9] My estimate is a reduction in Schwab's net interest income of $500 million to $1.5 billion if the Fed cuts rates two more times. Against a starting base of revenue that should exceed $10.5 billion, that hit would be tolerable as Schwab would likely post pre-tax margins near 30-40%. There are several variables and assumptions involved, however, so even that range could
[10] The deal seems likely to get approved given the current antitrust environment and the merits of the merger, but there are no assurances and things could change.

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