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How to Play Bank Reform: Q&A

Laurie Kulikowski – 03/26/10

NEW YORK (TheStreet) — Peter Sorrentino, vice president at Huntington Funds and the senior portfolio manager to the **Huntington Real Strategies Fund**, says the myriad of financial sector regulatory reform proposals making their way through Congress presents an opportunity to banks.

Sorrentino, who spoke with *TheStreet* earlier this week, says that investors have several ways to play the reform trade, including buying shares of safe, straightforward lenders like **UMB Financial** (UMBF) and **Hudson City Bancorp** (HCBK), or investing in a well-diversified company like **JPMorgan Chase** (JPM). Or investors can simply buy into “the smartest guys in the room,” represented by shares of **Goldman Sachs** (GS).

TheStreet: How attractive is the bank sector given the reform overhang right now?

Sorrentino: It creates an opportunity. Anytime you’ve got this kind of uncertainty, there is a hesitation to buy into the group. We saw that with health care over the last year and a half. That uncertainty, while it’s lingering out there, does create some very good opportunities within the sector and you could play it a couple of different ways. You could play it on assets being undervalued or you could play it on just buying very high-quality names that, once the smoke clears, are really going to take advantage of the competitive environment.

Which proposal has you most concerned in regards to limiting bank profitability?

The question on oversight for the consumer. This is one of those things where it’s well intentioned but it’s the law of

unintended consequence. The change of the Community Reinvestment Act of 1994 created a huge market in subprime, which sort of opened the door to the debacle that we just experienced. Again, well-intentioned to get people into homes, but the net effect was that it ended up with banks lending money to people that couldn’t pay it back. The same thing could be said for other changes that may come down the road. If there are businesses out there that are not profitable, what will happen is that the banks will simply quit supplying credit to those areas or quit doing business in those areas. What will happen is if this in fact comes into place and these kinds of restrictions are there, I think you’re going to see an odd landscape of the variety of products and who they’re offered to.

Sen. Dodd’s bill has gotten a lot of fanfare. What do you believe are the chances of it passing and if it does pass, will the final version have real clout and be able to exact true change?

I think there is a very good probability that it does pass... The problem with it is, it still doesn’t solve the fundamental issue which was that there needs to be a single financial regulator that oversees all financial activities within the U.S. The fact that there wasn’t uniformity was an opportunity to essentially skew the system by doing products that in effect looked to one regulator just fine when another regulator would have spotted right away that they pose a risk to the system. So there needs to be a single, very strong regulator that basically provides transparency to the markets.

Another big topic is the “too big to fail” issue. If reform comes to pass in this area, will we indeed see large banks be forced to break up?

I think there is that potential. Fortunately none of the aspects that they talked about, whether it’s the “Volcker Rule” or some of the others for proprietary trading or private equity, aren’t that big of an issue to the traditional banks. The one standout, of course, is Goldman Sachs.

As far as the others go, there are opportunities for someone like a JPMorgan Chase if that were to happen. They acquired a great deal of assets from **Bear Stearns** at bargain basement prices that could actually be a windfall for investors if some of those businesses were spun out and shareholders of JPMorgan were given an opportunity to participate. That could be an enhancement as opposed to a detriment to the overall return prospects for that stock.

*How would the reform of **Fannie Mae** (FNM) and **Freddie Mac** (FRE) affect banks?*

Fannie and Freddie, they’ve got to be corralled and the issue about whether they’re full facing credit backstops that have to be worked out. The proposal, I think, that made the most sense was essentially let them self liquidate over the span of the next three years. Then again, there are too many political aspects to this. The credit markets have shown a willingness to finance and to get deals done, if you look at a Countrywide, again there is a way to do this on the private side without the government sort of distortion of the marketplace. But it has to be done coherently and, again, the rules have to be transparent and pretty rigidly enforced, do Fannie/Freddie — if they continue to exist, even in the hybrid form — will [not] cause a market distortion. People forget that it was less than 10 years ago you had most of the major financial chiefs testifying in Washington

that Fannie/Freddie had gotten mission creep and were threatening to get into the credit card business. Even Jack Welch at **GE** (GE) was complaining that they were creeping into his businesses on the mortgage insurance side. The CEO of **PMI Group** (PMI) said 'Look, they're crowding us out. We're ending up with adverse selection...' That has to be addressed otherwise it's just a matter of time before we face this crisis again.

So which banks are safe bets, given the myriad of reform proposals?

If you want just a very solid, straight-forward lender, a company like a UMB Financial or Hudson City. These were banks that never fell prey to any of the gizmos of Wall Street [and] were basically very strong credit cultures. JPMorgan is a great asset play. On the other side, if you want to play the smartest guys in the room there is always Goldman Sachs. So

there is really a number of different ways you can play the sector right now.

What's your top pick?

UMB Financial. I'm just not smart enough to figure out where this is all going to go so I want to play with the guys who are very safe, very smart and just don't make mistakes. So I will go with a UMB.

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The holding listed below, which is referenced in the interview, made up the following percentage of Huntington Funds' portfolios as of 3/31/10:

Hudson City Bancorp	
Mid Corp America	0.52%
Macro 100	0.33%
JPMorgan Chase	
Fixed Income Securities	0.44%
Dividend Capture	0.34%
Macro 100	2.29%
Goldman Sachs	
Fixed Income Securities	0.44%
Short/Intermediate Fixed Income Securities	1.02%
Freddie Mac	
Short/Intermediate Fixed Income Securities	1.94%
Intermediate Government Income	1.77%
Mortgage Securities	0.99%
Intermediate Government Income	1.55%
GE	
Income Equity	1.81%
Short/Intermediate Fixed Income Securities	1.02%
Fixed Income Securities	0.84%

Other holdings mentioned in this article were not holdings of any Huntington Fund as of 3/31/10.

