# M.A. Wright Fund

*Financial Services Industry:*
*Sector Analysis, Current Holdings Review & Correlation Matrix*

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# SECTOR ANALYSIS

Over the past decade, Financial Services (FS) companies have been able to generate earnings faster than most other sectors. Companies in this sector are facing a more treacherous competitive landscape than they have for decades. The strategic and operational challenges include the following:

- **Increased Competition:** Financial services firms today confront entirely new competitors. Banks, insurance companies, and securities firms are offering each other's products. Global financial services players are competing across borders, most notably in securities and asset management. And nontraditional competitors, such as manufacturing and retail firms, are providing financial products as well.

- **Impact of the Internet:** While many start-ups in this sector have not survived, competition over the Internet has made prices more transparent, increasing the cost of attracting consumer assets and putting downward pressure on margins.

- **More Sophisticated, Demanding Consumers:** The wealth of financial information available over the Internet and through traditional media has made consumers better informed when shopping for financial products. Consumers have also come to expect the ability to access their accounts and conduct transactions 24 hours a day, seven days a week.

- **Decline of Acquisition-Driven Growth:** Although acquisitions have been central to the growth strategies of many firms, growth by acquisition is now less feasible since many of the most attractive targets have already been taken. In addition, the market has become more skeptical of mergers and is penalizing merged firms that fail to achieve their earnings targets. An analysis by Morgan Stanley found that seven of 10 recent financial services mergers had their share prices decline an average of 26.8 percent relative to the share prices of the Morgan Stanley Bank Index between the merger announcement and the end of 2001.

Each of the main types of financial services firms – commercial banks, securities firms, and insurance companies – is feeling the effects of the more difficult competitive environment.

- **Commercial Banks:** The economic slowdown has caused problem loans to rise and venture capital profits to decline. Meanwhile, median deposit growth for the 30 largest U.S. banks comprising the Morgan Stanley Bank Index was just 2.8 percent in 2000 and 3.3 percent in 2001, compared to a range of 6.2 percent to 6.7 percent in 1996-1999. The median growth in earnings per share for the banks in the Morgan Stanley Bank Index dropped sharply from 9.2 percent in 2000 to 5.2 percent in 2001.

- **Securities Firms:** The securities industry's big revenue producers to date – mergers and acquisitions, and underwriting bonds and equities – face an uncertain future. For example, M&A volume in the last quarter of 2001 was only about 30 percent of the $600 billion volume in the last quarter of 2000. Given the uncertain outlook, valuations of securities and asset management firms lag valuations in the broader market. An analysis by Goldman Sachs found that five of the largest securities firms had an average P/E ratio of 15 in 2001, compared to a P/E ratio of 18.7 for the S&P 500. The firm predicts that the P/E ratios of the leading securities firms will lag the market again in 2002.

- **Insurance Companies:** Insurance companies depend on investment revenue, which has declined along with the stock market indexes in 2000 and 2001. Insurance companies continue to be undervalued compared to the broader stock market. Although the gap in P/E ratios has narrowed over the last year, the P/E ratios of both life and non-life companies have significantly lagged the P/E ratio for the S&P 500.

Although the industry as a whole has not met with investor favor, the market has become more discriminating in valuing FS firms. The view of investors is clear – firms that take the difficult steps required to outperform the competition have been rewarded with premium valuations, while those that lag behind have seen their valuations tumble. FS firms need to shift their approach. Firms that have become experts at acquisition now need to learn how to grow organically through delighting customers with better service and an improved value proposition. Firms need to rethink their service offerings, their business processes, and their core competencies. The only constant in today's financial services marketplace is change. Technology, globalization, mergers, convergence and other drivers are reconfiguring the entire landscape, as we know it. Whether in the banking, securities or insurance sector, businesses must expect the unexpected and look beyond the developed countries to maximize opportunities in the new century.

# CURRENT HOLDINGS REVIEW

## FleetBoston Financial Corporation - FBF

*Company overview*

FleetBoston Financial, one of the top 10 banks in the US, operates some 1,700 branches in the Northeast through principal subsidiary Fleet National Bank. Besides retail and business banking services, the company provides asset management, insurance, mortgage banking, checking, savings, and credit cards. The company also has significant student and mortgage loan operations. It has some 250 offices in about 25 other countries, with a strong presence in Latin America. Its Quick & Reilly unit, one of the top discount brokerages in the US, offers online trading to the bank's Internet clients. Investment bank subsidiary Robertson Stephens underwrites IPOs and advises corporations on mergers and acquisitions.

*Recent Developments*

- Announced 4th Qtr loss of $507 million or $0.49 per share. Results include a $1.19 billion write down on accounts relating to Argentina.
- Full year earnings were $931 million or $0.83 per share v/s $3.9 billion or $3.52 per share in 2000.
- Loan exposures to Enron and Kmart amounting to $174 million and $100 million have been characterized as non-performing.
- CFO Gene McQuade said that no new capital would be invested in Argentina.

*Targets Revision and Comments:*

- We believe the decline in FBF shares has more than fully discounted the both the actual and potential future impact of Argentina woes.
- Management is “comfortable” with the consensus estimate of $3.20 per share expectation for Y 2002.
- However, despite the conservative write-downs made by the company, FBF has lost a lot of momentum in the market place.
- We recommend that the target price should be lowered to $39 in order to better align it with the potential upside.  The $39 price is a 13 times multiple on a lower end estimate of $3.00 EPS for Y2002.
- We also recommend lowering the stop target to $ 31.27 despite our belief that the current market price fully discounts the Argentina problem.  This is to create a little more “latitude” for the stock to absorb the negative development of the past few months.

**Revised Target Price: $39.00**
**Revised Stop Price: $31.27**

# Legg Mason, Inc. - LM

*Company Overview*

Legg Mason's feats include brokerage and asset management services. The company operates through several subsidiaries, including Legg Mason Wood Walker, a full-service broker/dealer and investment banker; Gray, Seifert & Co., which serves wealthy individuals and endowments; and Legg Mason Fund Adviser, which serves as an investment adviser to mutual funds. Also among Legg Mason's offerings are corporate and public finance, insurance and annuity product sales, and commercial mortgage banking services. The company operates primarily in the eastern and southern US and in Canada, Switzerland, and the UK. The company is expanding its services to affluent clients through a series of purchases.

*Recent Developments*

- Announced earnings of $41 million or 60 cents a share for the 3rd quarter ending Dec, 2001 v/s expectations of 53 cents a share. These results were the third best in the company's history.
- Assets managed were up 24% YOY to 170 billion and 8.3% Q/Q. Investment advisory fees grew 14.4% Q/Q and 25.6% YOY.
- Its flagship fund, the Legg Mason Trust Fund, outperformed the S&P 500 for the last 11 years.
- This was also the 47th consecutive quarter in which the firm set a new record in the revenues from its Asset Management activities.
- Acquisitions continue – over the last 6 months highly regarded small cap equity managers, Private Capital Management and Royce & Associates were bought.

*Target Revision and Comments:*

- Composition of the Assets under management (AUM) indicates that higher yielding equity assets are now a higher percentage of the whole. Three factors driving this mix shift are: acquisitions, net flows, and market appreciation.
- Consensus estimates for the FY2002 are between $2.15 and $2.17. Considering the Dec. 2001 Qtr earnings of 60 cents per share, we are comfortable with the consensus estimate.
- We are revising the target price to $57.28 which is an industry average (23.87) multiple for earnings of $2.40. We consider the consensus estimate to be very conservative, considering the impressive growth and performance of the company.
- The potential for upside in the AUM is strong if we take into account the fact that the equity markets have been in a slump for the last two years.
- We are also revising the stop price to $43.00 to ensure that we do not miss the opportunity to book profits in case of any negative developments.

**Revised Target Price:** **$57.28**
**Revised Stop Price:** **$43.00**

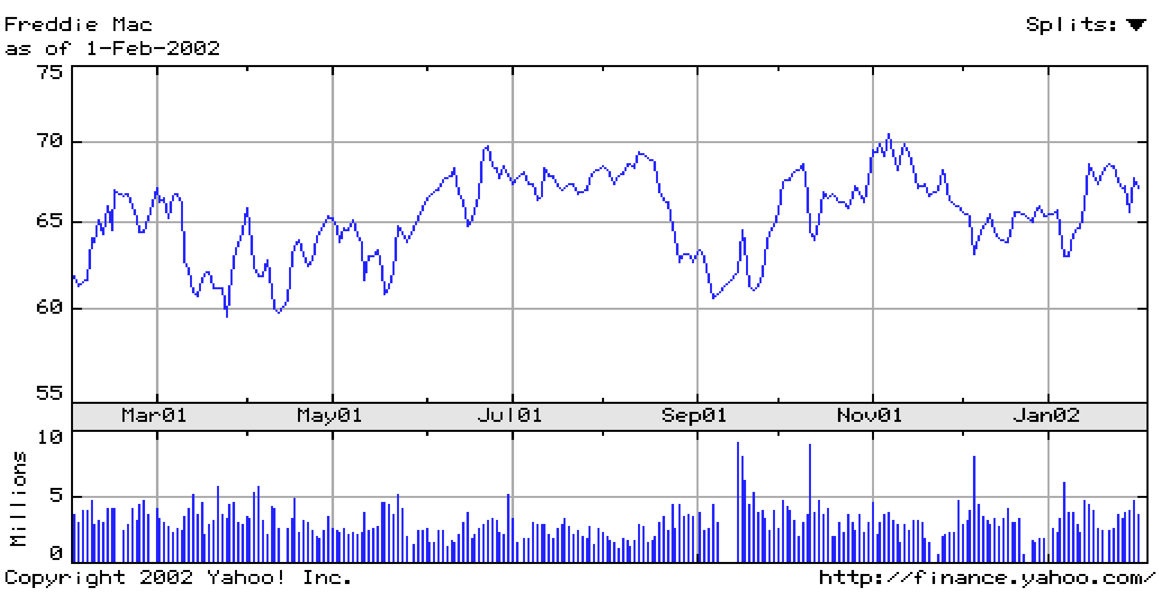
## Freddie Mac - FRE

*Company Overview*

Uncle Sam's nephew dabbles in mortgage banking. Formerly known as the Federal Home Loan Mortgage Corporation, congressionally chartered Freddie Mac provides liquidity in the mortgage marketplace by buying conventional residential mortgages from mortgage bankers, transferring risk from them and allowing them to provide mortgages to those who otherwise wouldn't qualify. Freddie Mac indirectly finances one out of six homes in the US, securitizing most of them for sale in the secondary market. Freddie Mac competes for mortgage purchases with big sister Fannie Mae, a fellow government-mandated company. Both have come under scrutiny for the advantages their federal charters give to them over private rivals.

*Recent Developments*

- Announced a 4th quarter EPS of $1.14 which reflects a growth of 28% YOY.
- Credit quality remains high although delinquencies were higher.
- Significant widening of net interest this quarter (7bps). Net interest yield was 87 bps vs. 80 bps in Q3 but expected to flatten out at 80 bps.
- Despite heavily investing in rate risk management and accelerating some infrastructure spending, the company still reported better than expected earnings.
- Added significantly more to the reserves this quarter.
- Retained portfolio grew 18% annualized for Q4.
- Bush Administration expressed concern for the growing size of Freddie Mac and Fannie Mae.



*Target Revision and Comments:*

- Estimated EPS for Y2002 is $4.60 to $4.90. We are comfortable with this estimate despite the apparent slowdown in the mortgage business because we believe that only the refinancing business volume will decrease. We also expect the adjustable rate mortgage business to increase and off set the loss in fixed rate business.
- We are retaining the target price of $77, which is approx., 17 times the FY2002 earnings. In our view, at current valuations, the company represents a relatively safer investment option with guaranteed business generation.
- The previous stop target of $60 is being revised to $58. We believe that the 52 week low of $58.80 is a crucial support level and hence if that level is broken, we may need to consider changing our view.

**Revised Target Price:** **$77.00**
**Revised Stop Price:** **$58.00**

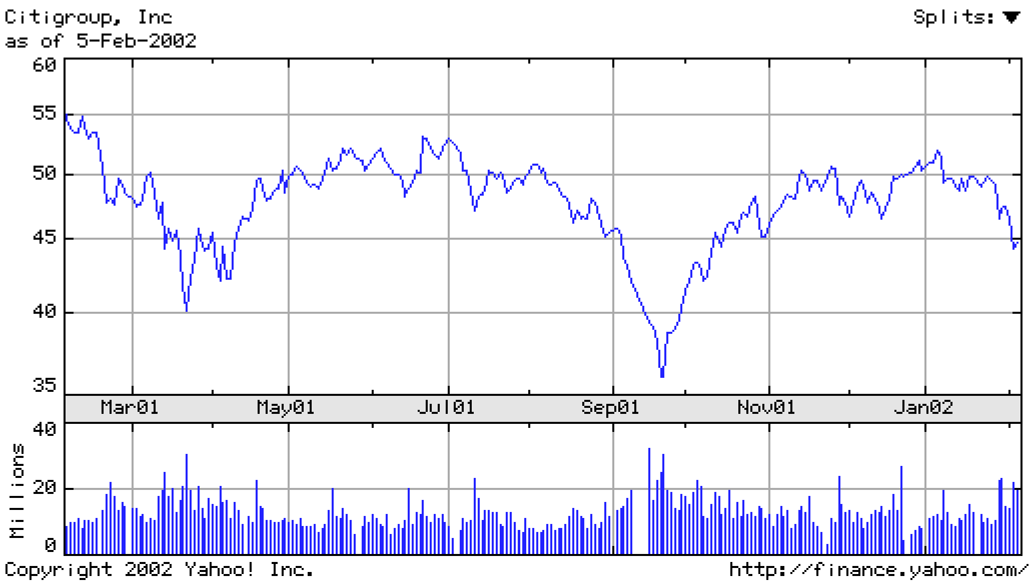
## Citigroup, Inc. - C

*Company overview*

The world's second-largest financial services company by assets (Japan's Mizuho Holdings is #1), Citigroup offers credit card, banking (mainly through subsidiary Citibank), asset management, insurance, and investment services through more than 2,600 locations in some 100 countries. Other subsidiaries include brokerage Salomon Smith Barney, insurer Travelers Life and Annuity, consumer-lending unit CitiFinancial, and Primerica Financial Services (term life insurance and asset management). Citigroup is also a leader in online financial services.

*Recent Developments*

- Citigroup announced that Bob Willumstad had been named president, a position that had been vacant since the departure of Jamie Dimon over two years ago. In our view, Willumstad has proven his mettle having successfully managed the company’s consumer finance operations across business cycles and major expansion, and we believe investors should view this change positively.
- Citigroup announced that it will spin out its Travelers Property Casualty (TPC) insurance business through an IPO of up to 20% and an eventual spin-off of the remainder. We view this as a positive for the company, as the property/casualty (P/C) business is the most cyclical and lowest returning of Citigroup’s array of businesses. The transactions will free-up capital for redeployment into existing business lines and could be used as a source of funds for future acquisitions.
- Citigroup reported fourth quarter EPS of $0.74, in line with our estimate and a penny above consensus. The number included the $700 million pretax impact from Enron and Argentina-related charges. The 13.8% year-over-year growth is all the more impressive given the current operating environment and the prominent front-page items.
- Management reiterated its plans to cut another $1 billion out of expenses in 2002, which should continue to dampen the overall growth in expenses.




**Revised Target Price:** **$65**
**Revised Stop price:** **$35**

## American International Group - AIG

*Company Overview*

Helmed by financial legend Maurice Greenberg, American International Group (AIG) is one of the world's largest insurance firms. Best known domestically as a leading provider of property/casualty and specialty insurance, AIG also has strong life insurance operations abroad and is a growing presence in financial services and asset management (purchases have included leading annuities firm SunAmerica and other companies specializing in retail financial markets). Other operations include auto insurance, mortgage guaranty, annuities, and aircraft leasing. The company operates in 130 countries; foreign premiums account for more than a third of its revenues. AIG has acquired US insurer American General.

*Recent Developments*

- American International Group shares have begun to recover from extreme weakness created by concerns broadly raised in the securities markets about accounting issues in general. As specific situations have been attached to names, the investor reaction has been to shoot first and ask questions later.

- In our opinion, American International Group has produced a long record of superior earnings performance at less volatility than the S&P 500 index, and hence ought to trade at a premium to the broader market. By our estimation, fair value for American International Group is in the range of 115%-125% of the S&P 500 multiple, getting us to our target price of $95-$105.

- Most recently, American International Group's share price dropped on news of a transaction involving PNC Corp., a bank that had moved approximately $1 billion of loans off of its balance sheet to a subsidiary of American International Group.

- Under the current situation, American International Group requires no accounting changes. Assuming that the transaction is unwound, assets and liabilities will be reduced on American International Group's balance sheet in equal amounts, with no change to equity or earnings. We would not view this as a reason to crush the American International Group stock multiple below that of the S&P 500.

- With respect to possible speculation linking UAL and American International Group's aircraft leasing subsidiary, the company indicates there is no exposure. The International Leas Finance Corp. web-page lists its customers, and does not include UAL in the list.


**Revised Target Price:** **$95**
**Revised Stop Price:** **$66**

## Washington Mutual, Inc. - WM

*Company Overview*

A financial services company committed to serving consumers and small to mid-sized businesses. Through its subsidiaries, Washington Mutual engages in the following lines of business: consumer banking, mortgage banking, commercial banking, financial services and consumer finance. The Company's principal banking subsidiaries are Washington Mutual Bank, FA, Washington Mutual Bank and Washington Mutual Bank fsb. The banking subsidiaries accept deposits from the general public, make, buy and sell residential loans, consumer loans, and commercial loans, and engage in certain commercial banking activities. The Company originates purchases, sells and services specialty mortgage finance loans through its subsidiaries, Washington Mutual Finance Corporation and Long Beach Mortgage Company. In January 2002, the Company acquired Dime Bancorp, Inc.

*Recent Developments*

- Topped fourth-quarter earnings expectations, on strong account growth and loan volume. The bank posted a profit of $842 million, or 97 cents a share vs. $497 million, or 62 cents a share a year earlier. Analysts polled by Thomson Financial/First Call expected 95 cents a share on average. "Our record performance ... is a fitting end to a spectacular year highlighted by record earnings, account growth and loan volume," said CEO Kerry Killinger in a statement.
- The board also declared a cash dividend of 25 cents on the company's common stock, up from 24 cents in the previous quarter.
- Jan 15 - The largest U.S. savings and loan set the final terms of its $5 billion purchase of Dime Bancorp Inc.
- Jan 8 - Raised $1 billion from a sale of five-year notes; co-lead manager and bookrunner Credit Suisse First Boston.
- Moody's Investors Service rates Washington Mutual's existing senior debt “A3,” its seventh highest investment grade. Standard & Poor's rates it “BBB-plus,” roughly one notch lower.


**Revised Target Price: $38.22**
**Revised Stop price: $30.00**

## MBNA Corporation - KRB

*Company Overview*

MBNA, a registered bank holding company, is the parent company of MBNA America Bank, N.A. (the Bank). The Bank has two wholly owned foreign bank subsidiaries, MBNA Europe Limited, formerly known as MBNA International Bank Limited and MBNA Canada Bank. Through the Bank, the Corporation is an independent credit card lender and an issuer of affinity credit cards, marketed primarily to members of associations and customers of financial institutions. In addition to its credit card lending, the Company also makes other consumer loans and offers insurance and deposit products. The Company is also the parent of MBNA America (Delaware), N.A., a newly chartered national bank converted from a pre-existing state chartered bank that offers home equity loans, aircraft loans and corporate loan products. MBNA Corp. pitches cards to people with above-average credit ratings.

*Recent Developments*

- Historically, shares of credit card lenders swipe on suspicions that the Federal Reserve would boost interest rates as the economy showed signs of recovering.
- “It is sort of a schizophrenic reaction, one half worried about people not paying loans and the other worried about the Federal Reserve,” Matthew Park, an analyst with Thomas Weisel Partners said.
- The Federal Reserve's 11 interest rate cuts since January 2001 have boosted earnings of KRB, the largest stand-alone credit card lender. Lower rates allow the company to borrow more cheaply, and with the bulk of its customers paying fixed rates on their cards.
- Jan 23 - Securitized $1.0 Billion of Credit Card Receivables from the MBNA Credit Card Master Note Trust
- Jan 15 - Reported a 25 percent increase in fourth-quarter earnings, benefiting from lower interest rates the company was able to pass on to customers. Net income rose to $524.8 million, or 60 cents a share, compared with $423.8 million, or 48 cents a share for the fourth quarter of 2000.
- The corporation has averaged 25 percent earnings growth in each of the 44 quarters since becoming public. Earnings per share were one cent higher than analysts expected, according to market research firm Thomson Financial/First Call. The corporation gained 11.2 million new customers in 2001 by offering good deals on interest rates, said David S. Hochstim, an equity analyst at Bear Sterns.
- MBNA also approved an increase in the quarterly dividend rate from 9 cents to 10 cents a share.
- Although managed loan losses for the year were lower than the industry average at 4.74 percent, delinquencies -- at 5.09 percent -- were higher than analysts projected and non-interest income was lower than expected.
- “We expect an aggressive move by investors into well-run consumer credit sensitive stocks by mid-year,” said a results analysis by ABN AMRO Inc., a broker and banking group.


**Revised Target Price: $38.16**
**Revised Stop price: $30.00**

# CORRELATION MATRIX OF CURRENT HOLDINGS

| | AIG | C | FBF | FRE | LM | KRB | WM | LEH | DB | AC |
|---|---|---|---|---|---|---|---|---|---|---|
| AIG | 1 | | | | | | | | | |
| C | 0.765478 | 1 | | | | | | | | |
| FBF | 0.630262 | 0.67303 | 1 | | | | | | | |
| FRE | 0.203778 | 0.198521 | -0.1664 | 1 | | | | | | |
| LM | 0.488118 | 0.825173 | 0.459831 | 0.056378 | 1 | | | | | |
| KRB | 0.444947 | 0.758233 | 0.595209 | 0.018659 | 0.71711 | 1 | | | | |
| WM | -0.07167 | -0.13435 | -0.00748 | 0.29201 | -0.22474 | 0.150331 | 1 | | | |
| LEH | 0.755406 | 0.875274 | 0.799876 | -0.01039 | 0.741922 | 0.709446 | -0.02396 | 1 | | |
| DB | 0.592443 | 0.715102 | 0.833443 | -0.29211 | 0.662518 | 0.687286 | -0.16185 | 0.796277 | 1 | |
| AC | 0.500956 | 0.595066 | 0.346718 | 0.319591 | 0.32745 | 0.471316 | 0.153456 | 0.502186 | 0.144339 | 1 |

Although there are seven stocks that we are currently holding, the matrix includes the numbers for three other companies (LEH, DB, and AC) from this sector. The matrix for our portfolio holdings reveals the following:

- Citigroup and Legg Mason have the highest positive correlation factor of app. 0.83, while Freddie Mac and MBNA have the lowest positive correlation factor.

- Legg Mason and Washington Mutual have the highest negative correlation factor, while FleetBoston Financial Crop and Washington Mutual have the lowest correlation factor.

- Washington Mutual has a negative correlation with four other stocks in our portfolio (AIG, Citigroup, FleetBoston, and Legg Mason) indicating that it has moved differently than majority of our holdings.

- There is intra industry divergence in price movement as indicated by an app. -0.13 correlation factor for Citigroup and Washington Mutual and -0.007 factor between FleetBoston and Washington Mutual. However, the correlation factor between Citigroup and FleetBoston was 0.67.

- Washington Mutual has outperformed the S&P by 21.9 % and the industry by 12 % over the last 52 weeks. This divergence, we believe, reflects the market's preference for regional banking sector v/s the national banking sector.