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INTERVIEW

Where the Financial Crisis Is Headed Next

Interview With Sy Jacobs, Founder, JAM Asset Management

By LAWRENCE C. STRAUSS

THREE YEARS AGO, HEDGE-FUND MANAGER SY JACOBS TOLD *Barron's* that serious trouble was brewing in the housing market, predicting that "the bursting of the housing bubble [would] be a dominant theme for investing in financial stocks in the next decade." He was right. Jacobs, 47, is the founder of New York's JAM Asset Management, which runs two funds, both focused on financial stocks and closed to new investors. The larger entity, **JAM Partners**, follows a market-neutral, long-short strategy and has close to $300 million in assets. As of May 21, the fund's year-to-date total return, net of fees, was 9.6%, versus a 4.5% loss for the S&P 500. Its annualized return since inception in 1995 (through April 30) was 16.6%, compared with 9.9% for the S&P. The $45 million **JAM Special Opportunities** Fund invests in illiquid private-equity holdings. Jacobs' familiarity with financial stocks dates to the 1980s, when he worked as an analyst at firms like Salomon Brothers and Alex. Brown & Sons. To find out where Jacobs sees new problems emerging in the financials -- surprisingly, they're not in the subprime arena -- read on.

Chris Casaburi

"Bear Stearns was not the sacrificial lamb to the market gods. And avoiding that meltdown doesn't mean things are getting better -- yet that is how financial stocks and the market have acted since." -- *Sy Jacobs*

Barron's: *You were early in detecting the serious problems in subprime mortgages. That turned out to be a great call.*

Jacobs: About three years ago, we were worried about subprime specifically. And that view very much paid off for us as we were short a host of such companies. More than a year ago, in another interview with *Barron's*, we said subprime was already in a full meltdown mode, but the idea that subprime was somehow isolated was still popular. Our message was that the mortgage-credit tail was going to wag the capital-market and economic dog. That's coming to pass now.

Looking ahead, what do you see for the financials?

We believe the recent rally in financial stocks -- and for the whole market -- is a bit of a head fake that will prove to be a bear-market rally.

What's your premise?

After first ignoring subprime, people now are too focused on it and they're missing the broader storm coming -- that's the head fake. While the bursting of the housing bubble produced all sorts of headline-making losses for some, it is just starting to drag down the rest of the economy. Separate from subprime, you are seeing diminished ability for consumers to spend their home equity. The securitization market, which banks and finance companies use to get funding, has slowed. So we see consumer and business spending slowing; the economy will falter.

In a recent letter to your investment partners, you noted that you were very concerned about the health of construction loans. Could you elaborate on that concern for us?

I spent a week recently in California, visiting some troubled, or soon-to-be-troubled, banks. With home sales down so much, construction lending is becoming a problem. You have a lot of developers and home builders stuck with homes that aren't moving. And they are sitting on lots that have loans against them. Subprime is such a small piece of the banking industry, but construction lending is a core product. If the housing market stays weak for much longer -- and it seems to be getting weaker -- construction-loan losses are going to be a big problem.

After the brutal real-estate recession that occurred in the early 1990s, there was a sense that banks had finally learned their lesson and would be much better fortified for the next downturn. I take it you don't think that's true.

I take a pretty cynical view of whether bankers have gotten smarter. We've had a real-estate bull market ever since the early 1990s. I think you are going to see the same thing again. The number of banks that get taken over by the FDIC and disappear may not be as high as it was in the late-1980s and early 1990s because there is strength in the energy patch now. But real-estate lending institutions are the bulk of the community-bank world, and I think you are going to see a lot of banks disappear.

What's your sense of the prevailing views of the financials right now?

People are trying so hard to believe that the Bear Stearns crisis in March was some sort of financial crescendo and represents the bell that gets rung at the bottom, as if that happens. But just because we got saved from what would have happened that Monday if Bear went down doesn't mean we are saved from all the forces that conspired to get Bear Stearns to the brink in the first place. Bear was not the sacrificial lamb to the market gods. It got knocked down by the same winds that are affecting everybody else. Credit destruction is a process -- not an incident. And avoiding that particular meltdown doesn't mean that things are getting better -- and yet that is how financial stocks in particular and the market in general have acted ever since.

You're a fundamental stockpicker, but are there any interesting trends you see in the financials?

One of our themes on the long side is that local plain-vanilla, over-capitalized community banks, especially thrifts, are in a position to gain back market share in the lending business. And they have real deposit franchises that they can fund themselves with. They have been losing market share to the **Countrywide Financials** [ticker: CFC] of the world for a generation. Now, though, they are going to gain a lot of that market share back, because they suddenly have a funding advantage, relative to the larger financial firms that have been securitizing their loans. That market has been discredited. We're long lots of micro-cap ways to play this, but they're too illiquid to mention here.

Table: Jacobs' Picks...[1]

Jacobs' Picks...

Company	Ticker	Recent Price
Hatteras Financial	HTS	$24.85
MGIC Investment	MTG	11.85
...And Pans		
Wells Fargo	WFC	27.70
Hudson City Bancorp	HCBK	17.79
BB&T	BBT	32.83

Source: Bloomberg

Fair enough. Let's discuss some of your holdings, starting on the short side.

The first one is **Wells Fargo** [WFC], trading at 12 times '08 estimates and 2.7 times tangible book; the group trades at less than two times book. The Wells Fargo name has a storied past and gets the Warren Buffett halo effect because he owns a lot of the shares. But if you look back at the last real-estate recession in the early 1990s, the Wells Fargo side, focused on California, had a lot of credit problems in the real-estate area, and the stock underperformed during that period. The Norwest side, which has more exposure to the Midwest, still has a lot of consumer-credit exposure. Of particular concern is the bank's portfolio of home-equity loans.

What's the big worry there?

Home-equity line of credit (HELOC] is 16% of their portfolio. More than a third of their HELOC exposure is in California, which is now developing very badly on the home-price and employment fronts. And delinquencies and losses are already rising pretty sharply. But they also have a big unfunded exposure to the undrawn lines of credit. Also, despite their reputation for being conservative, their loan-loss reserve at the end of March was lower than their annualized charge-off rate for the first quarter. Given the prospects for rising losses that we see, that's not conservative. We think they will disappoint this year and next and, as a result, their premium multiple will go down.

Wells Fargo, however, is known as a well-run bank. One example of that is the company's reputation for being very effective at cross-selling its products.

We're most concerned with their exposure to home-equity loans at the top of a real-estate bubble. Remember that home-equity lines of credit sit on top of first mortgages. So if home prices depreciate, which is what is happening now, and a home goes into foreclosure, the home-equity line often gets wiped out. The first mortgage holder can get most of their money back, but the home-equity line absorbs all of the loss.

Let's move on to another short position.

BB&T [BBT], which operates in the Southeast. The stock trades at 11 times '08 earnings and 2.5 times tangible book. It's bounced about 30% off its lows in January. They've gotten a pass because, to some extent, their core Carolina and Virginia real-estate markets were among the last to roll into home-price depreciation. So their non-performing assets are still low. But we listened to the **Toll Brothers** [TOL] conference [call] recently. [Chairman and Chief Executive] Robert Toll graded the markets they operate in and he gave Charlotte an F-minus for current home-building conditions and Raleigh a C-minus. We're also concerned that they have 4% of their portfolio in Alt-A mortgages, which are between prime and subprime, and 20% in construction loans.

As with many of the financials, there was this big relief rally on first-quarter earnings. The thinking was these results weren't so bad, but we think that more credit losses are ahead of us.

How about a different short holding?

Hudson City Bancorp [HCBK], which is based in New Jersey. The shares have gained about 60% from their July '07 lows and now trade at 21 times '08 estimates and two times tangible book. They have a wholesale funding and asset-generation strategy, which allows them to keep expenses low.

Could you elaborate on that?

Basically, they borrow funds from the Federal Home Loan Bank of New York and use repurchase agreements. So they, in effect, purchase money, more so than relying on deposits. In addition, they buy most of their assets, usually through brokers. A big chunk of their assets are first mortgages and mortgage-backed securities. So for the most part, they are not a retail originator of loans, and they are benefiting from the steepness of the yield curve.

And, even with all that, they will earn less than a 10% return on equity this year, so I just don't get the valuation. Furthermore, when you have a wholesale business model, that means you don't really have a valuable franchise that another bank would pay much for. So a recent stock price represented approximately a 100% premium for their core deposits, which is how bank acquisitions typically get priced. And I don't think their deposits are worth nearly that much to a buyer. Everything looks great for them now, if you a call 10% ROE great. But they are not immune to credit risk in a recession and a weak housing market. I also think their loan-loss reserve at 0.15% is very low, relative to others'. When the Fed rate-cutting cycle is over, I don't want to own a spread play with credit risk that's trading at two times book.

Let's move to the long side of the ledger. What financial firms do you like?

One is **Hatteras Financial** [HTS], based in Winston-Salem, N.C. They are a mortgage REIT. We bought it in a private placement last year and it recently went public at $24 a share. They own all agency adjustable-rate securities, so there is no credit risk here. The market capitalization is about $630 million.

What's the biggest risk for this firm?

I'd say it's yield-curve risk, but, trading at just over one times book value, it's well- factored into the price. We estimate that they will earn $4.50 to $4.75 a share from mid-year '08 to mid-year '09, once the IPO proceeds are invested. As a REIT, they will pay out all -- or nearly all -- of their earnings in dividends. So at 25 recently, the stock was sporting an expected yield of around 19%. We think the stock gets to 30 at least. Between the appreciation and the yield, it's a great total return.

Could you explain their yield-curve risk in a little more detail?

Like all mortgage REITs, they use leverage. They borrow at short-term maturities so they have been benefiting -- and continue to benefit -- from falling federal- funds rates. It's very similar to what Hudson City is doing. They are benefiting from falling short-term interest rates because they use the wholesale market to buy funds. And yet, somehow, the market is paying two times book for that, whereas you can buy Hatteras for 1.1 times book -- and Hatteras earns a 20% ROE, versus Hudson's 10%.

Last pick, please.

This is a more controversial long holding: **MGIC Investment** [MTG], in which we used to have a short position.

What made you switch to the long side?

The stock's down from north of 70 in early 2007 to around 12, bringing its capitalization down to about $1.5 billion. One reason we like the company is that it was able to raise more capital recently, something its competitors haven't been able to do. In March, they did a common offering that raised about $500 million -- so they've been able to raise liquidity and capital. At the same time, they are raising prices on premiums and tightening underwriting on the business now being written. The new business is being written based on lower home appraisals after the housing bubble burst -- and yet they are still showing good growth despite the fact that the whole industry has slowed down.

Our thesis is that once MGIC gets through writing down its old book of business, the new book will be very profitable and valuable. Even applying our bearish mortgage-credit outlook, we don't see more than another $4 or $5 per share of losses in the next two years. So current book value of $24 should bottom in the high teens in '09 and start rising from there. They'll be quite profitable after that, given their better margins and more conservative underwriting of the current book of business. The stock should trade upward of two times book. So we see the stock, currently at around 12, as a double-to-triple over the next few years.

Thanks very much, Sy.