

Given the markets recent rotation out of quality names and into bank stocks, below is our case on why Centerstone is not attending the Presidential election after-party.

Market participants currently believe that there is a material chance of interest rate increases by the Federal Reserve and the potential for higher inflation due to the economic stimulus announced by the administration. Along with an easing of the regulatory burden on the industry, the combination is believed to potentially alter the future return profile of the industry.

While the above assumptions may hold, we believe that much of the potential has already been discounted by the stocks themselves and that there is little margin of safety should those assumptions be unfulfilled. For instance, according to S&P Capital IQ, of the top 200 banks in the US with market capitalizations greater than \$200 million, the median Price to Earnings (P/E) multiple is 16x 2017 earnings, while the median Price to Book (P/B) ratio is now 1.6x. The “Big 4” (J.P.Morgan, Wells Fargo, Bank of America and Citigroup) do trade for lower multiples (13x on average), but the vast majority of the sector remains much more highly priced.

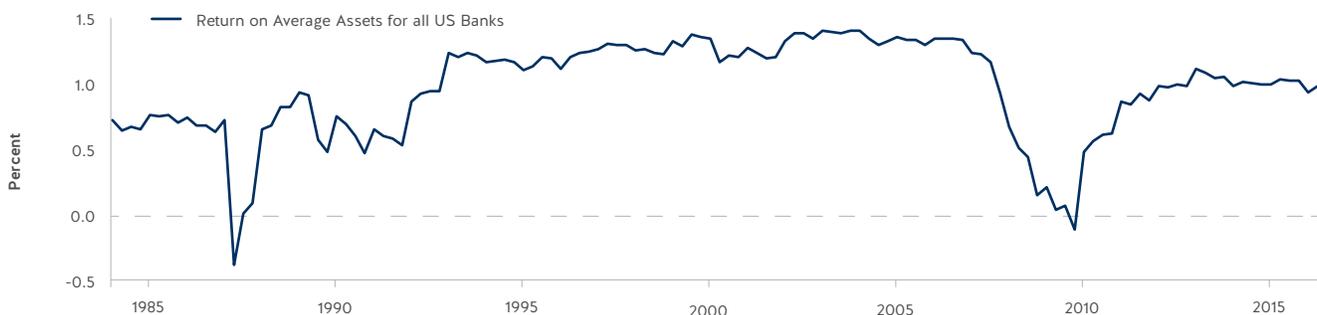
In terms of intrinsic value, we applied the standard bank valuation model (which equates a bank’s intrinsic P/B ratio to the relationship between its return on equity (ROE) and its cost of capital) and currently this valuation tool suggests that either bank stocks are overvalued or that banks will begin to grow their earnings significantly. It is the latter that is noticeably driving bank stock prices. We explored what would need to happen in order to justify current prices.

In our view, there are only a few ways that banks grow their earnings:

- ◆ primarily through loan growth (i.e. expanding the balance sheet’s leverage to fund more loans)
- ◆ an increase in returns on assets through higher lending spreads
- ◆ a combination of both

In order to justify current valuations and assuming that banks maintained their leverage ratios, bank returns on assets would have to go up to 1.5% from 1%, illustrated below. Net interest margins would need to shift dramatically higher, which has historically been accompanied or caused by higher inflation rates. There are many assumptions that would need to hold and in any case, one can see that such returns would be close to the returns during the bubble years.

**RETURN ON AVERAGE ASSETS OF ALL US BANKS**

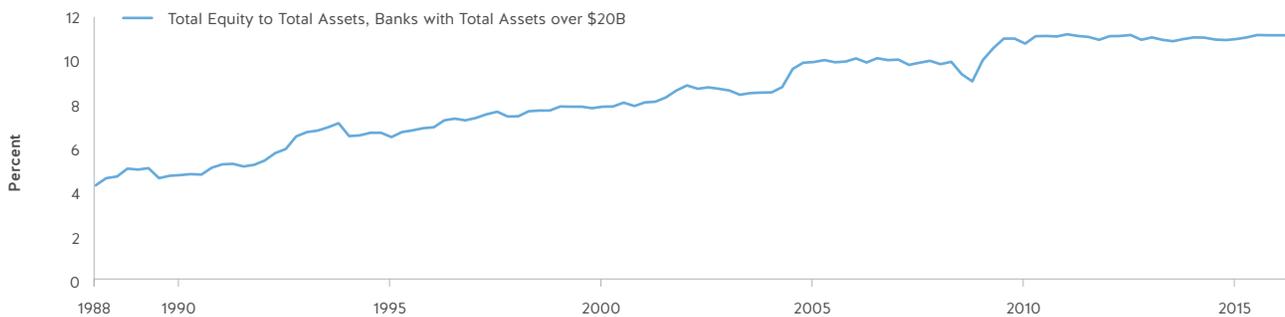


Source: Federal Reserve Economic Data



On the other hand, if returns kept constant, leverage (equity to assets) would have to drop to 8%, illustrated below. A re-leveraging of bank balance sheets is possible, but US bank loans have grown by 7% annualized over the last three years even under current leverage limits. Additionally, one would need to take a contrary view on the effects of demographics on loan demand. Considering both points, it is hard for us to see a dramatic re-leveraging of bank balance sheets.

### TOTAL EQUITY TO TOTAL ASSETS



Source: Federal Reserve Economic Data

The combination of the above leads us to conclude that this euphoria for bank stocks may be unwarranted. Bank stock prices have come to almost exclusively depend on a return to the heady days of the pre-bubble period. There is very little margin of safety and a great risk of disappointment.

We continue to stick to our knitting and invest in businesses that have strong balance sheets, business model durability and management teams with a good track record of capital allocation. The businesses we own such as Air Liquide, ICA Gruppen, EnerSys and Emerson Electric all continue to follow through on their strategic plans and their prospects are more in the hands of management teams rather than the fickle nature of government policy.

The commentary represents the opinion of Centerstone Investors as of November 2016 and is subject to change based on market and other conditions. These opinions are not intended to be a forecast of future events, a guarantee of future results or investment advice. Any statistics contained here have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. These risks may be more pronounced with respect to investments in emerging markets.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. All investments involve the risk of loss of principal.