Trust Banks Revisited

Last year, before I began my involuntary sabbatical from the Forum, I offered a presentation on trust banks. There are three such stocks: Bank of New York Mellon (BK), Northern Trust (NTRS), and State Street (STT). I have never followed State Street and confined my remarks to the other two.

Let me say clearly at the outset that trust bank stocks are deeply out of favor in the current market, and not without good reason. The question is whether they will continue to be so over the long term or whether their prospects will substantially improve in the years ahead and reward shareholders.

I began my presentation with a tongue-in-cheek commentary that questioned the business model of traditional banking. In traditional banking, bankers give money to strangers in the hope of getting it back with interest. I argued that business model is fundamentally flawed because people are no damn good. Examples in support of this argument are numerous.

By way of contrast, in trust banking people approach bankers with money in hand and ask the bank to hold it in trust for them. Trust bankers usually accept such offers—for a fee. It's fundamentally a good business model, with some notable exceptions. As always, the devil is in the details.

Both Bank of New York Mellon and Northern Trust operate both trust bank and traditional banking operations. Citigroup and JP Morgan offer similar trust services as a small portion of their overall operations.

Both trust bank stocks under discussion currently trade about 20% above their bear market lows.

<u>Bank of New York Mellon</u>: Bank of New York Mellon (BK) claims to be the oldest bank in the U.S. It traces its roots to being founded by Alexander Hamilton in 1784. It has a market capitalization of about $26B and currently trades at about 75% of book value.

It's cheap because it has become a troubled stock. It is being pursued by the federal government, several state governments (including Virginia), and several large public employee pension funds for supposedly manipulating foreign currency transactions to benefit the bank and defraud clients. These are serious allegations. The civil complaints are being led by Harry Markopolos, who is the stock analyst credited with revealing the schemes of Bernard Madoff. Markopolos and a former BK employee are seeking a large amount of compensation in the form of whistleblower rewards. Since this situation arose, BK has fired its CEO and replaced him with a longtime company executive whose job it is to clean up the mess he inherited from his predecessor who had been brought in from outside the company to boost performance.

The question for prospective investors is whether these problems are already more than adequately factored into the stock price. Numerous articles archived at www.seekingalpha.com argue strongly that BK is a bargain at the current quote and has strong upside potential.

Before his recent retirement, Marty Whitman manager of the Third Avenue Value Fund (TAVFX) was a proponent of BK. However, during a low point of the Great Recession Whitman warned investors to buy the same stocks he did—but three years later!

Finally, the BlackRock Global Allocation Fund (MDLOX) supposedly scours the world seeking the very best opportunities in stocks and bonds. The most recent shareholder report provided by this fund reveals that it holds shares of all three of the trust banks mentioned here.

Northern Trust: Northern Trust (NTRS) mainly flies under the radar on Wall Street. It has a market capitalization of about $11B and trades at a premium to book value of about 50%.

It is widely regarded as a very high quality stock by all measures and there has not been any hint of scandal or irregularity regarding the company. NTRS is one of only two large banks in the U.S. that did not reduce its dividend during the Great Recession. It operates the largest community bank in Chicago. During the dark days of 2008, lines formed outside branch offices of Northern Trust; not lines of panicking customers seeking to withdraw their savings, but lines of anxious customers wanting to deposit savings withdrawn from banks with lesser reputations for safety.

Late last year when NTRS was trading about 10% below the current quote and near its bear market low, Brian Rogers, the most prominent value stock manager (and CEO) of T. Rowe Price, cited NTRS as his favorite selection. More recently in a *Barron's* interview Rogers did not mention NTRS, but by then the stock price had risen.

Although NTRS is one of the country's largest providers of asset management services, it remains a mid-size player in the sector. It is regarded as a company that must eventually either buy or be bought. Currently it is making acquisitions and is expanding internationally, including in China. Several years ago it was rumored that Northern Trust had received two buyout offers at $65 per share. At the time Dick Bove, the dean of bank stock analysts, opined that the stock was only worth $58. That figure represents a substantial premium above the current quote.

So, in a market with fewer demonstrably cheap stocks than in the recent past, BK and NTRS may reward patient contrarians. But, they are not for the impatient or the faint of heart. Both stocks pay dividends of roughly 2.5%. Caveat emptor.

*This commentary does **not** constitute a recommendation to either buy or sell the stocks mentioned. These stocks are followed by prominent research services that can be accessed through the Fairfax County Public Library website at www.fairfaxcounty.gov/library. Do your own due diligence before making financial decisions.*