Berkshire
DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: Pass Fail? Not Quite + Mitigate Capital Gains Through Customization? – *June 26, 2020*

Good afternoon - Bank Stress Tests:
Last night, the Federal Reserve released the results of its "stress-tests."

The stress tests are composed of two parts:

DFAST (Dodd-Frank Act Stress Tests): Bank balance sheets are subjected to adverse conditions and regulators then decide if capital ratios are sufficient given likely losses. 34 of the nations largest and most important financial institutions undergo the tests. All the banks passed and comments from regulators are generally positive.

An additional wrinkle, the Fed is conducting a specialized version of the stress tests to account for COVID-19 losses. Results will be released in subsequent date and investors do not know the exact scenarios yet.

CCAR (Comprehensive Capital Analysis and Review). Banks submit their capital plans: stock buybacks, dividend policy, acquisitions. Regulators either approve or reject the institutions plan. Normally, the approval status and the banks plan are released immediately after DFAST results. This year, banks will release the plan they submitted, and the approval status on Monday. So we won't know specific company dividend policy until then. Banks will also need to submit an additional capital plan later this year.

However, the big news from this test relates to future dividend policy. The Fed imposed a blanket rule that banks may not pay out a dividend which exceeds the average of the last 4 quarter earnings. Stock buybacks are now expressly prohibited.

Side note: From a technical perspective, we simply don't understand why the regulators would eliminate stock buybacks. They should just set the level of capital allowed to be returned to shareholders and allow banks to decide how to allocate it. After all, if the money is being returned to shareholders why should it matter to regulators if it's a dividend or share buyback? As long as the ending capital ratio is tolerable it really doesn't matter from a corporate finance perspective!

While the cap on dividends is not entirely welcome:

- The measure is not overly draconian – there were fears of mandatory cuts or suspensions industry wide.
- Floating dividends with earnings is reasonable given the fluid nature of Covid, and gives the Fed and the banks ability to change policy as needed
- With one exception, banks in our portfolio fare reasonably well under this new formula and therefore we believe they do not face imminent dividend cuts.

*Average EPS estimated eps (3q19 actual to 2q20 estimated) vs. current dividend (payout ratio)

- **Bank of America (BAC):** $.49 eps vs. $.18 div (37% payout)
- **JP Morgan (JPM):** $1.76 eps vs $.90 div (51% payout)
- **M&T Bancorp (MTB): $**2.69 eps vs. $1.10 div (41% payout)
- **PNC Financial (PNC):** $2.26 eps vs. $1.15 div (51% payout)
- **Wells Fargo (WFC):** $.42 eps vs. $.51 div (123% payout)

**Bloomberg, Barclays estimates*

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Dividend Highlights

- Dividend growth can often provide transparent insight into a company's fundamentals and vitality.
- Dividend growth can provide an attractive stream of increasing cash flow to satisfy many financial objectives.

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It's worth noting the banks we cover increased loan loss reserves by a whopping 4-5 times in 1q 2020 and will likely to do the same in 2q. Despite these losses, banks were still profitable highlighting the durability of the balance sheets. Dividend yields remain attractive "as is" and prices already reflect a lot of doom and gloom. So while not a clear "pass" it could have been much worse.

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https://www.investmentnews.com/advisers-shouldnt-be-afraid-outsource-portfolio-management-194342

Have a good weekend!

Regards,
Gerry

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