CAPITAL MANAGEMENT

Bank of America

2023 has been an amazingly frustrating year for bank shareholders.

The fundamentals have generally been pretty good, particularly for the big banks, but the bears have been quite successful in driving prices down based on dire innuendo, or even bank runs on several banks that ended up failing as a result. One bear target has been

Bank of America (BAC), due to its held-to-maturity portfolio, which is under water after the rapid rate-hiking of the past two years. These myopic bears are focusing on an issue which would only be highly relevant in the event of a bank run and in the absence of the BTFP Fed mechanism; and they ignore the fact that the HTM portfolio was a hedge against lower rates, as many of BAC's assets and businesses are benefitting from higher rates, as reflected in the stellar financial results being produced each quarter. Investors focused on fundamentals and not driven by fear based on a one or two sentence quip to generate clicks will be well-rewarded in the common stock of Bank of America.

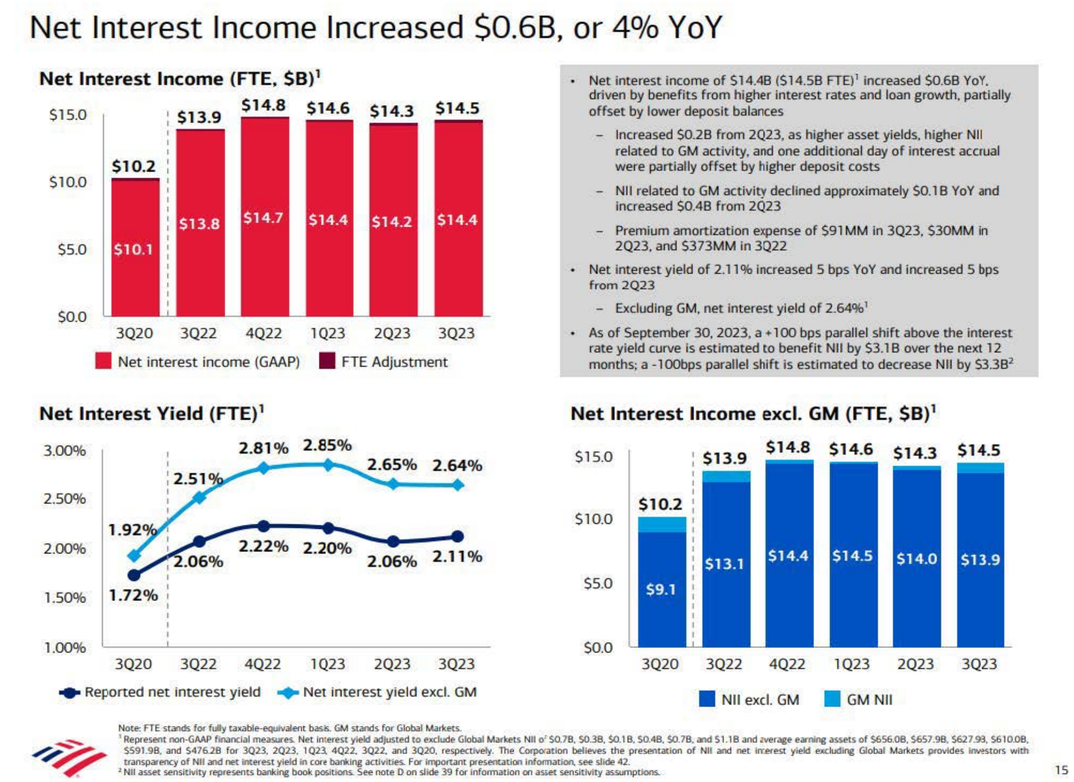
Bank of America's business is thriving. In Q3, the company added over 200K net new checking accounts, marking the 19th consecutive quarter of growth.

They added 1.1MM credit card accounts and over the last year, have added a record 3.8MM consumer investment accounts, along with $51B net client flows. Global Banking ahs added more than 1,900 new clients YTD and business lending revenue is up 26% to $2.6B. The company has generated $8.8B in Global Transaction Services revenue YTD, which is up 20% YoY. Global Markets has posted the highest YTD sales and trading revenue in over a decade, with Q3 culminating in record equities sales and trading revenue. The company hasn't had a trading loss day in 2023. Global Wealth and Investment Management has added 7,000 net new relationships across Merrill and the Private Bank, up 20% YoY. Assets under management flows have been $44B over the past year. By just about any metric, the company is performing exceptionally well. Management has done a great job driving operating leverage nearly every quarter, with very few exceptions, despite the inflationary environment.

On October 17th, BAC reported very strong financial results. Revenue of $25.2B was up 3% YoY, while net income of $7.8B was up 10% YoY, resulting in EPS of $.90, up 11% YoY. The company generated an extremely healthy ROTCE of 15.5%, or an ROE of 11.2%, hardly the numbers of a struggling bank. Net interest income of $14.4B was up 4% due to higher rates and loan growth.

Many of Bank of America's loans adjust higher as rates increase, providing a hedge to its HTM portfolio, which flows through NII, but this fact seems to always be ignored by the bears. Noninterest income of $10.8B increased by $51MM on the back of higher sales and trading revenue and asset management fees, offset by lower other income. The provision for credit losses was $1.2B, which included a net reserve build of $303MM. NCOs of $931MM increased YoY and sequentially, but remain below pre-pandemic levels, which was a pristine era for credit.

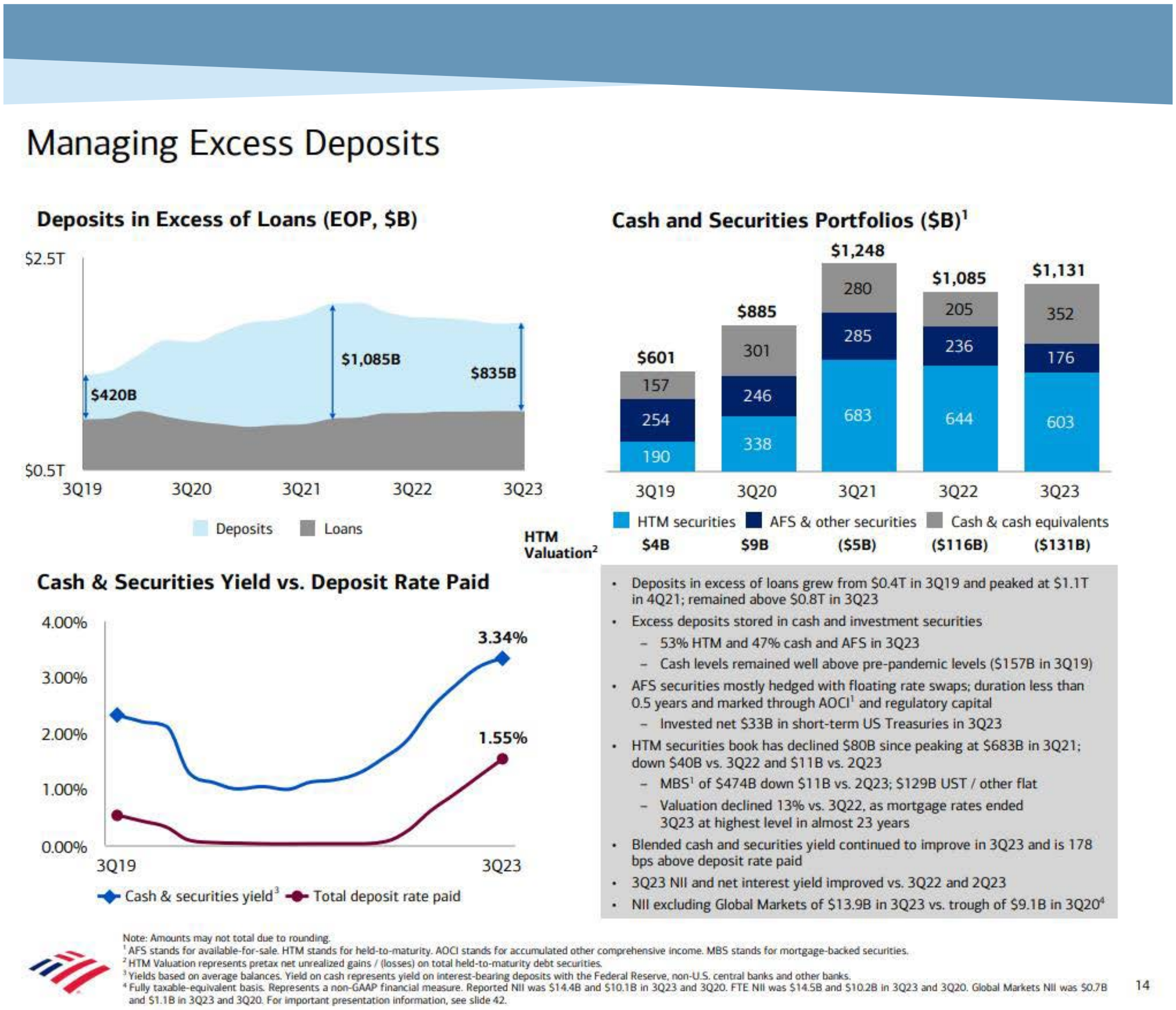
Bank of America ended Q3 with a CET1 ratio of 11.9%, which stood 240 bps above regulatory minimums. CET1 capital increased $4B sequentially to $194B. Global liquidity sources are abundant at $859B, while deposits of roughly $1.9T increased modestly, providing absolutely no rationale whatsoever for the company to have to do anything regarding the held-to-maturity portfolio other than let the bonds mature at par. BAC is one of the best positioned banks for potential higher capital requirements, as the potential requirement based on 20% RWA inflation would be a CET1 ratio of $195B, so BAC is basically there, and will of course continue to generate ample capital. The bank is producing well over $7B in organic capital generation each quarter on average to put things into perspective, so there should be substantial room for buybacks, *which are hugely accretive at current prices. BAC's tangible book value per share at the end of Q3 was $23.79, up 12% from $21.21 a year ago. Book value per share stood at $32.65, up 9% from $29.96 a year ago. Bank of America increased its dividend by 9%, after paying $1.9B in dividends and repurchasing $1B in common stock in Q3.*



The bear hysteria surrounding HTM has been a textbook bear-raid technique. Where were these mark to market aficionados when the banks had massive mark to market gains when interest rates were declining? Were they claiming that the banks were overly capitalized as a result? Of course not. Let's not forget that the Financial Crisis basically ended when they stopped mark to market accounting as it simply was a doom loop of lower prices, begetting more selling irrespective of the underlying economics of the securities, requiring continuous capital raises.

Once companies could just hold the securities and collect the cash flows, many of the most "toxic assets" ended up being the best performing over the next 5-10 years, and I wouldn't be surprised to see the same thing occur with the HTM portfolios, especially when we do get a recession and rates likely drop as a result. Meanwhile, the portfolios will continue to amortize, with Bank of America's amortizing by roughly $10B a quarter, with the money then able to be invested in T-bills.

Bank of America's excess deposits to loans grew from $420B in late 2019 to well over a trillion by the end of 2021. While hindsight would tell us that the best course of action would have been to stay in Treasury-Bills, the risk would be that rates would decline further as they had been, which would really hurt NII. BAC hedged that risk by buying longer-term securities, knowing that it would still be a massive beneficiary to higher rates. These aren't subprime CDO assets where there is a lot of question as to what price they will be at in maturity. These are pristine Treasuries, GSE mortgages, etc., that are likely to mature at 100, and which now have quite attractive yields to maturity. Importantly, BAC's cash and securities yield has been increasing at a solid rate, and in Q3 was 178 basis points above the paltry 1.55% deposit rate paid. BAC pays a low rate because they provide a litany of products and services to their customers, and many of their deposits are core operating deposits, not investments, which can easily be transitioned into CDs. It's one of the most valuable deposit franchises in the world. The bears seem to omit that Net interest income has risen by roughly $4B per quarter since the



3rd quarter of 2020, which highlights the hedging element inherent int the HTM portfolio. Imagine a recession where rates decline rapidly due to some major fear-induced event, the HTM portfolio will rapidly appreciate in price, providing a hedge against NII, which would likely decline over time if rates stayed low for longer. It's very indicative of the quality of bank that Bank of America is, in that they were able to grow deposits in Q3, when everyone and their mother is reaching for yield, yet the price paid is lingering at just 1.55%. If rate hikes are over, all this hysteria will just seem sillier and sillier in hindsight.

Credit quality is another major strength for Bank of America, as exhibited by holding up very well even in the worst-reserving quarters of the lockdown of 2020. The bank currently is holding $8.167B of 1.78% of Consumer Loans and Leases in reserves, which is 2.56x annualized NCOs. On the Commercial side, the allowance of $5.120B, or .87% of loans and leases, compared to just .35% of loans and leases being non-performing. The trading businesses benefit from higher volatility, which typically occurs, helping to subsidize higher credit reserves when necessary.

At a recent price of $27.62, BAC trades at just about 7x earnings, which is frankly absurd given the quality of the enterprise. The stock trades at just 1.16x tangible book value and a meaningful discount to book value, despite consistently generating an ROTCE of over 15%. The bear case requires interest rates to keep going up, depositors to flee causing a liquidity squeeze irrespective of BTFP, which was designed to eliminate that, and regulators to take some type of ridiculous action. Remember, the Fed has the most HTM losses of anyone. Nobody wants forced selling of Treasuries, simply to recognize MTM losses at the least opportune moment possible. The bear case is a sales pitch. They show $131B in MTM losses due to higher rates and for the investor that's attention span is a Tik Tok video or a sentence, panic can be induced. I believe Bank of America is worth upwards of $40 per share, which is around 12.5x my normalized earnings estimate of around $3.20 per share.

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