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Preamble: I'm sure many of my remarks in this commentary will be controversial. I hope you will share your feedback. Importantly, this report is **not** a recommendation to buy BAC or any stock mentioned. I'm simply using my research and data to share a thought process on a particular sector as it relates to a larger investing climate. It is for Advisor use only.

More than ever, clients are looking for reasons to again believe in America, the economy, and most relevantly the financial markets.

If you are looking for the most glaring symbol, look no further than investor reaction to owning large US banks – like Bank of America, Citigroup, Goldman Sachs and JP Morgan. To many they are the symbol of all that went wrong and representative of a financial system in shambles and the decline of America.

Virtually no one wants to own them. In fact in my 20 years career, there has never been a group of stocks more universally hated then large US banks. Their stock prices, many of which are below total liquidation value prove this. Merely mentioning them at client meetings as potential candidates for ownership is pretty much grounds for ending the meeting!

Many think the proxy for the Presidential election is the unemployment rate in November. If it's low, Barrack Obama wins reelection. If it's high, he's out.

I say "Tell me the price of Bank of America stock in November and I'll tell you who wins the election." **Bank of America is the proxy for America.** One way or another it touches nearly 40% of our entire economy. And nothing seems to relate the dour mood of the country quite like investor sentiment towards this stock.

And like America, believe it or not, there is actually a bullish case for it and others in the banking sector.

Here it is.

A typical cognitive error made by professional and amateur investors is recency bias. This simply means that recent events count more heavily than older events in decision making.

For example, immediately after the 2005 hurricane season when Katrina, Rita, and Wilma

wreaked so much havoc, most people thought we were in a new era of much more severe hurricanes. Even though data from the past 75 years would suggest that a repeat of the 2005 hurricane season was highly unlikely, weather and insurance forecasters relied more heavily on recent experiences.

The same is true for investors' perception of the banking industry. It went through the greatest of all financial hurricanes. For example, Bank of America's loan loss estimates reached 4.1% of total loans in 2009. The actual losses actually came in substantially lower. This gross over estimation of loan losses was very typical among many large banks during that time. Many continued to release reserves bank into earnings in subsequent quarters.

However, loss rates in the prior two recessions peaked at 1.6% and in normal times average about .6%. 30 full years of data show that. Many Wall Street analysts are now forecasting that for the next 4 years loan losses will average 1.5%--almost 3 times the historical average. 1.5% losses are more consistent with terrible recessions. We believe that loan losses may actually be less than historical averages. Why? It is because underwriting standards over the past few years have been incredibly stringent. Many of the loan products that played a large role in the banking crisis, such as, no money down and negative amortization loans are gone. What is coming down the pipeline in 2012-2015 are only the absolute top loans from top tier clients, and these loans are stringently underwritten. Even the best clients have substantial credit checks and have to put a lot of money down – if they can even get a loan. It's pretty much "the crème de la crème". These are the loans that will dominate the loan books in 2014, not the toxic garbage that were in the 2008 and 2009 numbers.

Loan losses that come in below estimates will have a powerful effect on earnings. For example, Wall Street estimates 2014 earnings for Bank of America will be $1.50 per share with loss estimates of 1.60% of loans. Many are afraid to go out on a limb because it would be too far a deviation from the current trend. And if our theory about losses comes true, that is only .5% of loans go bad, the true earnings could come in around $2.30. Even putting an 8 P/E ratio on those earnings gets you to an $18.40 stock price in 2014. What Wall Street analyst is going to take that type of career risk by putting such a big number on the shares? If he or she is wrong in the short term, they probably lose their job. So they all muddle around a consensus.

In addition to having very strict underwriting criteria, banks are also now sitting on record capital levels. Banks have built a massive "levee system" in anticipation of future "Cat-5" financial hurricanes – hurricanes that many never come. This large capital base actually makes them systemically less risky – even to the point where someday investors will someday believe these are actually pretty sound institutions and potentially pay substantially higher prices - ironically because they'll be safer.

We've analyzed a number of financial institutions and the same general thesis holds for many of them to varying degrees. Some of these financial institutions are appropriate for the type of portfolios we run and some are not. I illustrate with Bank of America (which is not currently in Berkshire portfolios) because it is the most extreme example of potentially misplaced bearishness and illustrates the thinking on the entire sector and its relationship to the entire market.

No one seems to be talking about it (and that's the opportunity) but there really is a path forward for many companies in this sector.

And as they go, so goes America.

Believe.

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