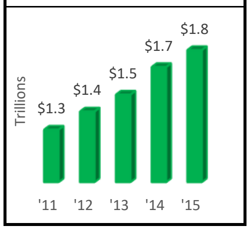
SELECTIVE
WEALTH MANAGEMENT

Wells Fargo Company
October 11, 2016

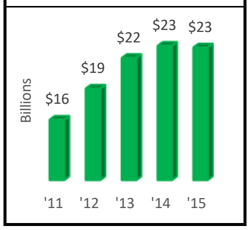
General Overview

Wells Fargo (WFC) is one of the largest banking institutions in the world with more than $1.8 trillion dollars in assets under management. Despite the enormous size, the company is old fashioned in the way that it operates – providing traditional banking solutions to individuals, small businesses, and enterprises located in the United States. Unlike many large banks, WFC lends money both responsibly and prudently – as evidenced by the phenomenal performance through the Great Recession and after. The business model for the bank is relatively simple. WFC earns profit by serving customers in three key areas: Community Banking, Wholesale Banking, and Wealth Management. By focusing on controlling costs WFC has been one of the most efficient and well run banks in the United States for nearly 25 years and fits the mold as a Selective Company.

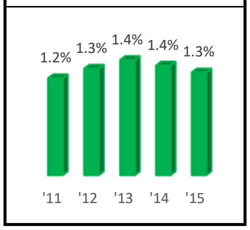
Total Assets
$1,862,084,000,000
5-Year CAGR = 8.0%



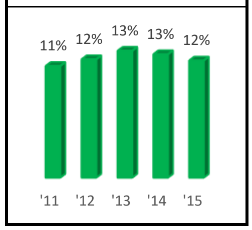
Net Income
$22,894,000,000
5-Year CAGR = 9.6%



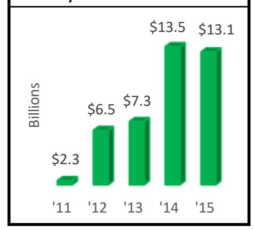
Return On Assets
1.28%
5-Year AVG = 1.32%



Return On Equity
11.9%
5-Year AVG = 12.1%



Distributed Earnings
$13,057,000,000
Payout Ratio = 57%



Purchase Logic

We purchased WFC following a gradual decline in price after a news report that revealed a scandal involving phony checking and credit card accounts created on behalf of customers. Opening accounts on behalf of customers, such as an empty checking account, is illegal and a serious cause for concern. The news sent the stock price to new 52-week lows. We did not take our purchase of WFC lightly – integrity is an absolute must for all Selective Companies. Due to the ethical nature of the scandal we will break down the purchase logic of WFC into two distinct parts:

1) Our view of the company as a financial investment and,
2) Our view of the company from an ethical perspective.

<u>Financial Considerations</u>

For more than 100 years WFC has been one of the most profitable and well run financial institutions in the United States. The company has always had prudent lending practices and did not participate in many of the foolish lending practices that led to the financial crisis of 2008. The company earns high returns on equity and assets, both critical metrics for a bank, and ranks #1 or #2 in all important categories among major banks. We purchased WFC at an average price of $45.21 per share and with 5,045,547,142 shares outstanding the market capitalization was $228 billion. In the last twelve months the company earned roughly $23 billion dollars – making our effective purchase price less than 10x earnings. This earnings yield of 10% compares very favorably to alternative investments in today's market as illustrated by the table on the following page:

Table 1: Investment Comparison
As of October 11, 2016

Investment Type	Details	Yield
US Treasury	10 Year	1.5%
Certificate of Deposits	1 Year	1.3%
Triple AAA Bonds	Vanguard Index (Mid-Duration)	3.4%
High Yield Corporate Bonds	Vanguard Index (Mid-Duration)	5.7%
Average Business	S&P 500 Earnings Yield	4.6%
Wells Fargo	**Earnings Yield**	**~10%**

WFC offers a reliable business with strong prospects for growth at a price that is much lower than comparable investments. The company has earned more than a 12% return on equity for the last decade and maintains one of the highest levels of profitability in the industry. We do not believe the future earning power of WFC will be materially impacted by the recent news and the financial merit of the purchase is exceptional.

We expect WFC to clean up the recent scandal and slowly regain customer confidence. We anticipate no growth in the near term as opening new accounts will be difficult for a few years. WFC currently has the lowest net income margin (the interest spread between liabilities and assets) that it has experienced in many years. Our investment thesis does not hinge on a material improvement in the net interest margin, but if rates were to rise and the margin improve it could increase earnings meaningfully.

Limiting organic growth is the fact that WFC has been close to the 10% maximum for aggregate deposits a single US banking institution is allowed to have in the US. This limits the prospects for growth long-term in the community banking divisions – the largest and most profitable division for the company. With a regulated maximum size WFC has been distributing more earnings in recent years through increased dividends and a growing share repurchase program. We expect the share repurchase program to accelerate over the next several years and even with no overall growth, the earnings per share of WFC will gradually rise. Due to the increasing size of the share repurchase program we view WFC as a Selective Buyback Company and as such we are more likely to maintain or increase our position in WFC if the market cap remains low or decreases. In the event the price of the business were to rise the effectiveness of the share repurchases would decrease and we would consider selling the business.

Ethical Considerations

Before diving into the specifics of the WFC scandal and how we view the company from an ethical perspective it would be beneficial to clearly describe the type of culture we expect at a Selective Company.

Cultural Expectations of a Selective Company

For a business to pass the Selective Process the company needs to have a culture of integrity that begins with management. We expect management to be honest, transparent, and have high moral principles. These characteristics are best evaluated by looking at the history of the individuals running the business – particularly during adverse times. What did leadership do in the past when an employee violated the company's code of ethics? Did they terminate the employee and emphasize that it would not be tolerated? How did management react during difficult market conditions? Were they honest and forthright about problems they faced? Is management generous and do they lead by example? By assessing these types of questions it is possible to learn about the quality of the leadership.

Selective Insights: Integrity in Action

An Example of Excellent Leadership

In the fall of 2016 LinkedIn missed earnings estimates and the price of the stock declined more than 50% in a single day. This had a huge impact on the lives of employees at the firm because stock compensation is a large part of all employee pay packages. Following the decline, Jeff Weiner the CEO, in an amazing act of leadership donated all of his stock awards, totaling $14 million, to his fellow employees. Less than 6 months later Jeff organized the sale of LinkedIn to Microsoft and all employees saw their stock options recover their entire value. This selfless act by Jeff is not surprising – he is beloved by his employees for his kindness and was voted the highest-rated CEO in 2014. When leaders go above and beyond to serve their employees it is a positive sign that they are leading with integrity.

Management must personally demonstrate integrity, but also, they must be capable of passing these same values on to employees at the company. When employees are inspired to uphold high ethical standards a culture is built that embodies the code of ethics set in place by leadership. Building a culture of integrity can be challenging and it is naïve to expect perfection from any organization. Whether governing a town, a class room, or a business – there will be individuals that do not conform to expectations. We understand that businesses are made of people and we have realistic expectations about what it means to have a culture of integrity.

Selective Insights: Realistic Expectations

The Safest City in America

In 2015 the safest city in the United States was Irvine California. It is reasonable to assume that when it comes to adhering to the law the culture in Irvine is stronger than most cities in the US. Irvine had a population of 243,000 residents and the total number of reported crimes during 2015 was 3,165. This seems like a tremendous amount of crime – so what should we conclude about this statistic? Should the leaders in charge of governing the city be replaced? Are they unethical people?

Obviously, as the safest city in America it wouldn't make sense to remove the leadership. A more logical conclusion would be that governing people is difficult. In the safest city in the United States there was 1 crime per 76 individuals in 2015. If a governing body fails to reduce crime to zero we would encourage them to consider ways to improve, but would not consider their governance a failure. We believe that when it comes to governing people it is irrational to expect perfection. The hallmark of great leadership is how they respond to ethical failures. A constant striving for improvement is expected. Therefore, when it comes to governance: Perfection is the goal, however, excellence can be tolerated.

"To summarize our expectation for the ethical culture at a Selective Company:

Perfection is the goal, however, excellence can be tolerated."

The Culture of Wells Fargo

In the early fall of 2016 a news article shed light on a scandal at WFC where sales representatives were opening empty accounts for customers that did not request them. This behavior is illegal, unethical, and inexcusable. As we analyzed the culture at Wells we first had to answer "What happened?"

What Happened?

It was discovered that a substantial number of accounts that were not requested by customers were opened by WFC employees. In the news, the reported figure was 2 million, however, careful examination shows the number to be significantly less. The 2 million phony accounts was estimated based on the number of unused, zero balance, or inactive accounts at WFC (as determined by the reporter that published the article). Since the announcement of the scandal WFC has been personally calling individuals with unused, zero balance, or inactive accounts to determine if these accounts were requested by customers. After reviewing 10% of the total number of accounts it appears that roughly 75% of these empty accounts were requested and 25% were not. The estimated number of illegal account openings is likely closer to 500,000. This is still an unacceptable number and there is no excuse for unlawful behavior.

When examining the damage done to the individuals that did not request accounts it is evident that the damages to each customer was minimal. Most accounts were empty and charged no fees – but on some occasions the customer was charged annual fees, overdraft charges, or had their credit score impacted. Why would employees open accounts that generate little or no revenue for the bank? The answer is simple – it helped employees hit sales targets for "new account openings". Up to this point, the investigation has revealed that the fees charged to unauthorized accounts resulted in a total of $5 million dollars in damages to clients or an estimated average of $10.00 per account. This number may increase as the investigation is carried out. These damages should never have occurred and customers must be repaid in full with interest. Those are the facts up to this point. The next question, "Why did it happen?"

Why Did It Happen?

The average American household has 14 financial products. An example of a household with 14 products: A husband and wife that have two checking accounts, three credit cards, a mortgage, a student loan, two car loans, a savings account, a Roth IRA, two 401(k)s, and a safe deposit box. It was, and is, the ambition of WFC to meet the needs of this household. Typically, all of these financial products are at several financial institutions and WFC has made it their goal to handle 8 out of 14 of these products. The company believes they can provide higher levels of service, lower costs, and earn more profit per customer if they win market share from their competitors.

In order to accomplish this goal the WFC executive team had to create an incentive system to motivate and reward employees that helped meet these customer needs. They put together an incentive system where bonuses were tied to the number of new accounts each branch was able to open each year. A sales incentive of this type is extremely common in all industries across the United States and is a logical way to compensate individuals. During the last 5 years the number of financial products per household that WFC served increased substantially and is now more than 6.19 products per household. The incentive system seemed to satisfy the needs of customers, increase market share for WFC, and incentivized employees to higher levels of productivity. The incentive system *seemed* ethical, rational, and effective.

However, with the incentive system in place 5,300 employees opened phony accounts between 2011 and 2016 in order to hit various sales goals. I suspect the reason so many ethical people opened up phony accounts was that it seemed 'harmless'. The customer typically paid no fees and was not impacted – they simply had an empty checking account in their name. The employees were incorrect and on occasion an account closing or annual fee was charged which totaled between $10-$20 dollars. The temptation to open an account to meet a sales goal probably seemed benign to these employees. The behavior of these employees is not excusable and the law was broken. When an employee was identified as having opened an unrequested account for a customer they were terminated and the customers repaid in full. Firing an employee, training someone new, and reimbursing the customer with interest is not profitable for the bank. Opening up these accounts was a ***money losing*** activity for WFC. It was not a scheme to increase profits at the bank – it was done by entry level employees in an attempt to personally obtain their bonuses. The executive team was not attempting to juice profits at the bank.

How Did Management Respond?

In 2011 it was brought to the attention of John Stumpf, CEO, that nearly 1,000 individuals were fired during the year for opening phony accounts on behalf of customers. The executive team thought that there were policies and procedures in place that zero balance accounts would be automatically closed and not count towards sales goals. These employees had found a loop-hole and the executive team attempted to improve processes so that it wouldn't occur again the following year. However, in 2012, 2013, 2014, and 2015 the total number of employees fired continued at roughly 1,000 per year. This number seems alarming and astronomical. Why did management not change the incentive system so that employees did not feel pressure to break the law and meet sales goals? Is John Stumpf capable of creating a culture with integrity? To answer this question consider the following example:

Imagine we are evaluating the performance of a CEO at Random Bank. Random Bank has $1.9 billion in assets under management, 20 branch locations and 252 employees. The CEO is focused on building a culture of high quality lending, excellent customer service, high levels of integrity, and a strong sales culture. During an executive meeting a regional manager reports to the CEO that one employee at one branch opened phony accounts to meet sales goals. The CEO asks how the situation was handled. The regional manager reports that the employee was immediately fired, the phony client accounts were closed, and the clients that were impacted were refunded $900 in fees. The CEO of the bank debates if the incentive system he has in place at the bank needs to be reevaluated. He knows that managing 252 individuals is very challenging and 251 employees performed very well under the current system. The CEO elects to make no changes to the current system for several years, despite one employee out of 252 being fired each year.

The situation at WFC was identical to the one described above – however – WFC is a much bigger bank. The table below shows the parallels between WFC and Random Bank:

Institution	Employees	Fired Employees	% Fired
Random Bank	252	1	0.40%
Wells Fargo	268,000	1,060	0.40%

After analyzing the news about WFC it is understandable how John Stumpf could have made the poor decision to maintain the incentive system when it created illegal activity among 0.40% of his employees. We strongly believe the incentive structure should have been removed and re-evaluated. Maintaining this incentive system after knowing it was creating illegal behavior was a mistake.

Prior to our purchase of WFC the incentive system was removed entirely. Additionally, John Stumpf volunteered to personally forfeit $41 million in pay which was 8 times more than the total damages done to customers. The board of directors seems to believe, as do we, that John Stumpf made an honest mistake by maintaining this incentive system.

To summarize, the behavior at WFC was inexcusable. It is our opinion that the moral failures that occurred among the WFC employees was due to an incentive structure that put undue pressure on otherwise honest people. This incentive structure was an honest mistake and not a malicious scheme for profit. We believe it will take some time to regain customer trust at WFC, but that this mistake will slowly fade into the rear view mirror as the company rebuilds the culture of excellence.

Key Metrics

The key metrics we will be monitoring at WFC are Revenue, Net Income, Return on Assets, Return on Equity, Provision for Loan and Lease Losses, Capital Ratios, Distributed Earnings, and the Share Count. The real world business drivers of each metric are described below.

Revenue

The three operating segments at WFC are Community Banking, Wholesale Banking, and Wealth Management. Community banking holds deposits for individuals and small businesses. These deposits are then responsibly loaned to other individuals for mortgages, home equity lines of credit, equipment financing, and more. Community Banking is the largest profit center for WFC representing 50% to 60% of profit in any given year.

Wholesale banking is similar to Community Banking, but rather than serving individuals WFC is serving large enterprises - such as corporations. The types of activities are very similar and include checking accounts, investment accounts, lines of credit and financing. This segment represents between 30% and 36% of profits in any given year.

The last segment at WFC is wealth management. This particular division deals with helping individuals plan for retirement through financial planning and investment products. It also includes money management, such as WFC managed mutual funds. The business generates revenue by charging a percentage of assets under management for these services. Wealth management typically accounts for between 5% and 10% of profits each year.

Selective Insights: A Wells Fargo Relationship

A Sample Customer Relationship

Chris recently graduated college and landed his first job. He walks into a WFC branch location and opens up a checking account so his bi-weekly pay checks can be automatically deposited into his account. The WFC associate asks if he is interested in opening a savings account to earn more interest and a credit card to build his credit history and earn points on purchases. He agrees to both. Chris leaves the branch satisfied that he now has a checking account to setup automatic bill payments, a debit card so he doesn't have to carry cash, a credit card he can use to earn points, and a savings account to start building his wealth.

A few years later, during a routine visit at the bank, the WFC teller notices Chris has a healthy balance in his savings account and asks if he might be interested in investing a portion of his savings into the stock market, which will have superior returns over long periods of time. Chris is interested and sits down with a WFC financial advisor (obviously this should be done at Selective Wealth Management, but for the sake of our example, we'll continue…). The financial advisor helps Chris put together a financial plan for retirement and moves a portion of Chris' savings into a WFC mutual fund. Once the financial plan is in place the WFC associate finds out Chris is looking for a new home. He approves Chris for a mortgage and a few weeks later the bank loans Chris the money required for his home purchase.

Continued…

Selective Insights: A Wells Fargo Relationship (Continued)

A Sample Customer Relationship

A few more years pass and Chris is now running his own business with a few employees. A WFC associate asks if Chris would like his payroll processing to be done through WFC and if he needs help with a payment terminal to accept electronic payments. Chris says yes to both. Throughout the years WFC has served Chris with excellence in each area of need. He now has 8 financial products.

How Wells Fargo Earns Revenue from Chris

1. *Checking Account – WFC earns revenue by charging a modest annual fee, charging merchants an interchange fee on all debit card purchases (typically 0.3% of the purchase), and by charging Chris for out of network ATM withdraws. Also, WFC loans money to other customers from its massive deposit network. Interest is earned on the loans WFC makes and these loans are made possible by checking account deposits, such as Chris'.*
2. *Savings Account – WFC pays Chris interest on his savings account, which is an expense for the bank. However, the bank then loans the money in the savings account to a home buyer at a higher interest rate and earns a spread – known as the net interest margin.*
3. *Credit Card – WFC earns revenue by charging merchants an interchange fee on all credit card purchases (typically 0.5% of the purchase), and if Chris has a balance at the end of the month WFC earns interest on the credit loan.*
4. *Financial Planner – WFC earns a percentage of Chris' investment balance each year for financial planning. The company has more than 15,000 financial advisors.*
5. *Wells Fargo Mutual Funds – The financial planner would recommend Chris purchase WFC mutual funds. These mutual funds typically charge a fee each year based on the assets in the fund.*
6. *Mortgage – WFC loaned Chris money for his home purchase and receives interest each month as Chris repays the loan.*
7. *Payroll Processing – WFC creates payroll stubs and handles all tax preparation (W-2s) for Chris' employees. The company may charge $15 per pay period plus $4 per each employee.*
8. *Merchant Acquirer – WFC provided the payment terminals at Chris' retail stores. Every time a customer swipes a debit or credit card at Chris' stores WFC earns a small percentage of the purchase.*

The WFC business model is built on relationships, such as this one, with more than 27.4 million customers. Each relationship generates a modest amount of revenue, but together they combined to form one of the safest and most profitable banks in the world.

The safety and strength of WFC business model is built on these simple and diverse products. Further adding to the safety of WFC is a list of services the bank does not provide. WFC is very different from other large banks, such as Goldman Sachs, Lehman Brothers, or JP Morgan Chase – the company does not make material investments in derivatives, esoteric products, CDOs, swaps, etc. With immaterial proprietary trading WFC is an old fashion bank serving one customer at a time. The simplicity of the business model gives us great confidence in the ability to weather financial storms.

We anticipate revenue growth between -5% and 12% per year with a 10 year average of 5%. This growth will largely be fueled by inflation, advances in the general economy, and deepening customer relationships. The average American has 14 financial products and it is the vision of WFC to provide at least 8 of these products to each customer. The company currently averages 6.19 products per customer leaving substantial room for growth.

Net Income

The net income at WFC is the free cash flow after all expenses, including taxes, have been paid. As a general rule, the net income reported by a bank closely aligns with owner earnings – meaning the income that is reported can be fully distributed to the owners of the business without impeding the competitive position of the business. An important metric when analyzing a bank's net income is the efficiency ratio. This is the ratio of expenses dividend by revenue. The lower the number the more efficient the bank. WFC is one of the most efficient banks in the United States and converts revenue into operating income very efficiently.

Efficiency Ratio							
Rank	Company	2015	2014	2013	2012	2011	Average
#1	US Bancorp	54%	53%	52%	52%	52%	53%
#2	Wells Fargo	58%	58%	58%	59%	61%	59%
#3	Citigroup	57%	71%	63%	72%	65%	66%
#4	JP Morgan	67%	68%	73%	70%	72%	70%
#5	BB&T	70%	67%	66%	70%	80%	71%
#6	Bank of America	69%	88%	77%	86%	82%	80%

It is our expectation that net income will rise between 0% and 10% each year with an occasional terrible year. Terrible years, when net income is negative, happen from time to time as an owner of a bank – particularly in recessions. This is to be expected and does not deter us from owning WFC. Attempting to time these difficult years is a very difficult task that we do not attempt. We are very comfortable owning WFC through both good times and bad.

Overall we would expect WFC to grow net income an average of 5% per year over the next 10 years. This growth rate is assumed because the earning power of a bank increases as total assets rise. Assets naturally rise with inflation and increases in wealth. If WFC maintained market share a real GDP growth of 2% and inflation of 2% would equate to WFC experiencing a 4% rise in net income as the US economy continues to grow. We anticipate an additional 1% growth per year through productivity gains and increases in the cross-sale of products. It would be very difficult for net income to rise faster than this over a 10-year period due to the restrictions on market share for large banks imposed by the Dodd-Frank act. No bank is allowed more than 10% of the total deposits in the US and WFC is close to the 10% limit. In the short-term, an increase in rates could materially add to the net income of the bank, but is not necessary for our investment thesis.

Distributed Earnings

Due to the limited prospects for growth we expect WFC to distribute the majority of earnings as dividends and share repurchases. We anticipate a payout ratio between 30% and 60% as dividends, with the remainder going toward share repurchases. Share repurchase activity at WFC is a relatively new activity and at the current price level shares will be retired quickly (between 1% to 3% per year). The combination of organic growth in net income and share repurchases would equate to an EPS growth between 1% and 13% per year with a 10-year average of 7%. When combined with the 3% annual dividend and potential price multiple expansion there is a high probability WFC will be a mid to high double digit return during our holding period. We intend to sell the position if the price multiple expands. Our logic is that the share repurchase program becomes less effective at higher price multiples and our earnings growth on a per share basis would decelerate.

Return on Assets (ROA)

ROA is an important measure of a bank's efficiency and profitability. The higher the ROA the more profitable the business. In the last 5 years an average bank, regardless of size, has posted a ROA of 0.75%. WFC nearly doubles this performance. ROA is calculated by dividing earnings in the last twelve months by the average assets in the last twelve months.

Example

TTM earnings = $28 million

TTM average assets = (Beginning of period assets + End of period assets) / 2 = ($3.7B + $3.8B) / 2 = $3.75B

ROA = $28,000,000 / $3,750,000,000 = 0.75%

This metric is important because it is a clear indicator of how well WFC is competing relative to its peers. If ROA is significantly higher than the competition it demonstrates superior performance and execution.

Return On Assets							
Rank	Company	2015	2014	2013	2012	2011	Average
#1	US Bancorp	1.44%	1.54%	1.65%	1.65%	1.53%	1.56%
#2	Wells Fargo	1.31%	1.45%	1.51%	1.41%	1.25%	1.39%
#3	BB&T	1.08%	1.19%	0.95%	1.15%	0.83%	1.04%
#4	JP Morgan	0.99%	0.89%	0.75%	0.94%	0.86%	0.89%
#5	Citigroup	0.95%	0.39%	0.73%	0.39%	0.56%	0.60%
#6	Bank of America	0.74%	0.23%	0.53%	0.19%	0.06%	0.35%

We anticipate WFC to continue to earn between 1.0% and 1.5% on assets each year – with the exception of the occasional terrible years – such as the financial crisis.

Return on Equity (ROE)

The return on equity is a measure of how profitable retained earnings are for business owners. This metric is calculated by dividend the net income by the total equity of the business. The more efficient a bank the higher the return on equity. This metric was more important for WFC during the 100 years of growth than it is today. This is due to the fact that the majority of earnings were retained and profits increased as a multiple of the ROE. Due to the limited prospects for growth, very little earnings are retained and the ROE is not as crucial moving forward as it was historically – but still very important. It is our expectation that WFC would maintain a double digit ROE on average over the next 10 years. Historically, the company has had one of the best ROEs in the entire industry as seen on the following page.

Return On Equity							
Rank	Company	2015	2014	2013	2012	2011	Average
#1	US Bancorp	14%	15%	16%	16%	16%	15%
#2	Wells Fargo	13%	13%	14%	13%	12%	13%
#3	JP Morgan	11%	10%	9%	11%	11%	10%
#4	BB&T	8%	9%	8%	11%	8%	9%
#5	Citigroup	8%	3%	7%	4%	6%	6%
#6	Bank of America	9%	3%	7%	3%	1%	4%

Provision for Loan and Lease Losses (PLLL)

The most important function when operating a bank is to always make sure you issue high quality loans. When a bank makes a bad loan and it is not repaid the collateral (typically a house) is foreclosed on and becomes property of the bank. The collateral is then sold at the market price. If the amount the bank lent is in excess of the amount recovered the bank reports a loss on the loan (known as a "charge off"). The bank must set aside funds from the operating income to cover these losses and maintain their equity capital.

Money set aside for bad loans is known as a provision for loan and lease losses (PLLL or "P triple L"). The provision is a leading indicator for bank – meaning they typically set money aside before the loans go bad based on current default rates and late payments. What differentiates WFC from other large banks is the responsibility and prudence with which they make loans. The company originates the majority of loans in house, with large down payments, to highly qualified borrowers. The outstanding underwriting discipline was clearly reflected during the financial crisis when the PLLL at WFC was the lowest, by far, of all major banks. This critical metric is key to our investment and gives us great confidence as owners of WFC.

Selective Insights: Analyzing Risk at WFC

A 30,000 Foot View of Loan Losses

The following example provides a high level view of how we analyze the risk of loan losses. The goal is to compare the pre-tax pre-provision income of the bank to charge offs in extremely adverse economic conditions. This comparison will shed light on potential losses that would occur to the equity capital during the worst of times. Below are the general steps we take in this evaluation:

1) *Calculate the Pre-Tax Pre-Provision Profit (PTPP Profit) in good times. For WFC this is roughly $36 billion per year or 3.79% of total loans.*
2) *Segment the loan portfolio by loan type, geography, and loan-to-value (LTV).*
3) *Estimate defaults for each part of the portfolio based on historical levels*
   a. *Example: Defaulted residential prime loans during the financial crisis reached a peak of 11% and commercial loans reached 9%. Analyze the worst default rates in history by loan category.*
4) *Estimate the market decline in value of the collateral for each segment of the loan portfolio. The decline in market value will be used to determine the recovery rates on defaulted loans.*
   a. *Example: Home prices in California fell more than 50% during the financial crisis, whereas, in central Virginia prices fell less than 10%.*
5) *Calculate the charge offs for each segment of the loan portfolio. This is performed by assuming the bank sells the collateral at the depressed market value (from Step 4) and subtracting this recovered amount from the original loan.*
   a. *Example: An $80 million loan portfolio with LTV of 80% in California would be backed by collateral valued at $100 million. If prices fall 50% the value of the collateral is now $50 million. For every $1 in defaulted loans only 5/8 will be recovered. An 11% default rate (financial crisis high) equates to $8.8 million dollars of default loans. Approximately 5/8 of this will be recovered by selling the collateral. The total loss on this would be 3/8 of $8.8 million or $3.3 million. This equates to a charge off rate of 4.13% as a percentage of loans. Repeat this for each segment in the loan portfolio.*
6) *Adjust the PTPP Profit downward for the non-performing loans and reduced economic activity.*
   a. *If 11% of the loans are in default the interest earned on this portion of the portfolio will not be received. Adjust the PTPP profit downward for the lost revenue.*
7) *Compare the PTPP Profit as a percentage of loans to the charge off rate.*
   a. *We believe the PTPP Profit for WFC is greater than the charge off rate in the most extreme financial conditions. This means WFC would post a profit under worse economic conditions than the financial crisis and equity capital would be preserved.*

WFC maintained high levels of profitability during the financial crisis which was a result of low average loan balances (less than 50% of total assets), diversified revenue streams (high non-interest income from other banking services and wealth management), and excellent underwriting. We believe WFC is the safest investment of the big banks.

Capital Ratios

A capital ratio is a financial measure used to determine how much cash a bank has as a buffer against losses. Since the financial crisis the amount of equity a bank must have as a percentage of assets to absorb potential losses has increased substantially. We anticipate that WFC will always remain above 10% Tier 1 capital to total assets. This is "well capitalized" according to the Federal Reserve Board and provides substantial safety to the owners of WFC in the event of a financial crisis.

Share Count

Historically, WFC was not very active in repurchasing company shares. Profits were distributed to owners through dividends or retained for future growth. In the last 24 months WFC has been spending an increasing percentage of profits on repurchasing shares. We believe this is due to the scale of the bank. As options for growth become more limited, due to size limitations imposed by Dodd-Frank, more capital is being returned to shareholders. We anticipate the share count to continue to decline as it has in the last 24 months as more profits are allocated to this activity. At low prices – this is an excellent use of capital and increases our ownership in the bank with no further investment from us.

Historical Performance of Key Metrics

Year	'11	'12	'13	'14	'15
Total Assets	$1,313,867,000,000	$1,422,968,000,000	$1,523,502,000,000	$1,687,155,000,000	$1,787,632,000,000
Revenue	$73,049,000,000	$78,869,000,000	$81,471,000,000	$82,952,000,000	$83,615,000,000
Net Income	$15,869,000,000	$18,897,000,000	$21,878,000,000	$23,057,000,000	$22,894,000,000
ROA	1.2%	1.3%	1.4%	1.4%	1.3%
ROE	11%	12%	13%	13%	12%
PLLL	0.6%	0.5%	0.2%	0.1%	0.1%
Equity / Assets	10.7%	11.1%	11.2%	10.9%	10.8%
Distributed Earnings	$2,333,000,000	$6,519,000,000	$7,253,000,000	$13,494,000,000	$13,057,000,000
Share Count	5,273,240,691	5,270,881,531	5,261,842,959	5,152,380,886	5,076,712,397

Summary of Key Metrics

Metric	Expectations
Revenue	-5% to +12% per year 10-Year average of 5% growth
Net Income	5% average growth over 10 years Occasional years with zero profits
Distributed Earnings	30% to 60% of net income as dividends 10% to 50% of net income as share repurchases
ROA	Between 1.0% and 1.5% per year Occasional year at 0%
ROE	Greater than 10% per year Occasional year at 0%
PLLL	Pre-Tax Pre-Provision Profit > Stress Tested Charge Off Rate (i.e. No losses during financial crisis)
Capital Ratios	Greater than 10% Tier 1 capital to Total Assets "Well Capitalized"
Share Count	Reduction of 0% to 5% of total shares outstanding per year 10-Year average of 3% reduction

The Moat Around The Metrics

The economic moat that protects WFC profitability is known "customer captivity". Each customer has a relationship with WFC that is similar to *Chris* from our Selective Insight example. Once a customer is banking with WFC they establish automatic bill pays, credit cards, mortgages, payroll processing, savings accounts, etc. The cost benefit of switching these services to a competing bank is almost never worth the hassle of making the switch. When switching costs are higher than the benefit we call these 'captive customers'. Occasionally a customer will switch, but with more than 27.4 million customers, no single customer represents a meaningful amount of revenue.

Following the scandal, we do believe a small percentage of customers will leave the bank or suspend business with WFC. However, the overwhelming majority will make no changes and the massive number of customer relationships will be stable. The sheer volume of relationships was slowly built over more than 100 years and will be very difficult for competing banks to replace. This makes the profitability at WFC reliable. We are extremely confident that the recent scandal surrounding the business will have very little long-term impact on the business model or profits of the bank. Additionally, growth in the overall business is not required as part of the investment thesis since we assume the overwhelming majority of earnings will be distributed as dividends and share repurchases.

Risks

Purchasing WFC in the midst of a scandal entails assuming several short-term risks – all of which are minimal. The actual financial impact of the scandal is immaterial, but the damage done to the reputation of the bank can have several short-term effects. It is possible that some customers will leave the bank, but we view this as low probability because the number of affected customers was low compared to the total number of customers, the damages to each individual customer was very slight, and banking in general has very strong customer captivity. Historically, scandals such as this one, create headlines that move that hearts of the people, but not the checking accounts of the people. What is more likely, is that in the short-term new account openings will be slow (if at all). Individuals seeking to open a new checking or savings account will very likely consider another bank. We believe that even this psychological aversion to banking with WFC will fade into the history books in the next few years and WFC will continue banking as usual. The fines and penalties associated with the scandal have thus far been immaterial and even if WFC is forced to pay customers 1,000x more than the damages done to each customer the fines would be paid with less than 90 days of earnings. We view this scenario unlikely.

The biggest risk of owning WFC is that the bank becomes complacent with lending practices. The most important part of any banking institution is making responsible loans. All evidence points towards excellence in this area for WFC. The bank continues to have the best lending practices of all the major banks, but we will monitor this closely. Another potential risk, although remote, is that regulators decide to break up the big banks. We view this as a low probability because banks have powerful lobbying groups, there are economies of scale to banking that benefit customers, and there is very little evidence that smaller banks are easier to regulate or reduce systematic risk to the economy. However, in the event that WFC is broken up, we believe that losses to shareholders would be minimal (perhaps zero). If the bank was broken up we would exchange our ownership of one large bank with $1.8 trillion in assets for the ownership of many smaller banks with a total of $1.8 trillion in assets. If the ROA remains relatively stable (it may dip due to losses in economy of scale) then the earning power of our divided banks would likely be close to the earning power of the present WFC. Either way, the probability of material losses are low.

Finally, as owners of a bank there is always the risk of tremendous financial calamity in the United States such as the Great Recession. We've carefully analyzed WFC's loan portfolio by loan type, geography, LTV, collateral, and estimated recovery rates to determine that the probability of loss for WFC during the most adverse economic times is remote. All-in-all, we believe WFC is a *simple* and *responsible* bank with 27.4 million captive customers that are well served. The total risk of ownership is very low.

Conclusion

In conclusion WFC is one of the largest banking institutions in the world with more than $1.8 trillion dollars in assets under management. The company is old fashioned in the way that it operates and built a business over 100 years serving one customer at a time. WFC lends money both responsible and prudently and focuses on simple products, unlike many other large banks with proprietary trading desks. We purchased WFC following a gradual decline in price after the recent account opening scandal. This scandal was inexcusable and it will take WFC several years to rebuild the trust of customers, however, they've taken the correct actions to get back on the right path.

WFC has an earnings yield that is double most alternative investments. We view the business as a Selective Buyback Company and, as such, we intend to own the company while the price remains depressed. We would be content selling if the price were to rise substantially. In the meantime, the key metrics we will be monitoring are Revenue, Net Income, Return on Assets, Return on Equity, Provision for Loan and Lease Losses, Capital Ratios, Distributed Earnings, and the Share Count. In these critical areas WFC ranks first or second among major banks. We expect the profits at WFC to continue and the culture of the company to be restored.

Works Cited

1) *WFC Annual Report - SEC Filing 10-K.* EDGAR, 2015.
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