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January 25, 2010

Industry View
**Attractive**

# Banking - Large Cap Banks

## Market Concerns over Proposal Are Overblown

**Investment conclusion:** The sharp decline in C, BAC, and JPM reflects more than the $1-3 per share cost that we estimate for exiting PE, hedge funds, and proprietary trading. They reflect more than the potential for an even greater change in industry structure than the proposal is suggesting. We believe their decline reflects market concerns that the Obama/Volcker proposal will limit credit availability, raise the price of credit, and slow economic growth.

**What's new:** Some investors are concerned that the Obama/Volcker proposal might ultimately mean that investment banks are forced to split from banks, even though they were explicit in saying no break-ups. We look at BAC, C, and JPM on an IB vs non-IB SOTP basis, and the stocks look cheap. With leverage at 12x for the overall companies, they do not look like there is any ING-type double leverage issues.

**Investment Implication:** Buy BAC and JPM. Credit getting better throughout 2010 as jobless claims decline. We expect that we are hitting peak political and regulatory uncertainty. Uncertainties are likely to persist until Senate's version of the financial reform bill is clearer (we expect some time in the spring) and Basel 3 guidelines are clearer (post QIS analysis due in spring).

**Why not wait until these uncertainties are resolved?** Credit. Credit is set to improve in 2010 given lower jobless claims. If you wait for finality on Basel 3 and Senate deliberations, you risk the stocks working as losses decline.

# Investment Case

## Summary & Conclusions

The sharp decline in C, BAC, and JPM reflects more than the $1-3 per share cost that we estimate for exiting PE, hedge funds, and prop trading. They reflect more than the potential for an even greater change in industry structure than the proposal is suggesting. We believe their decline reflects mkt concerns that the Obama/Volcker proposal will limit credit availability, raise the price of credit, & slow economic growth.

Some investors are concerned that the Obama/Volcker proposal might ultimately mean that investment banks are forced to split from banks, even though they were explicit in saying that there proposal did not signal a break up of the banks. We look at BAC, C, and JPM on an investment bank (IB) vs non-IB SOTP basis, and the stocks look cheap. With leverage at 12x for the overall companies, they do not look like they have any ING-type double leverage issues.

More than the threat of exiting private equity, hedge funds and proprietary trading, and more than the market concerns of a split of the banks into IB and non-IB businesses, we think the challenge in the Obama/Volcker proposal is the risk to credit spreads, credit availability and slower economic growth.

2 parts of the proposal point to this possible outcome of higher borrowing costs, lower credit availability & slower growth:

- A wide definition for proprietary trading could drive down liquidity in fixed income and equity markets, driving up borrowing costs and reducing credit availability.
- The proposal to limit growth of the largest banks by limiting their share of non-deposit liabilities to their current share. Companies are managed to win and grow. Companies aren't structured to give up market share. This market share limitation could slow growth as the largest co's are not able to reinvest fully in their businesses. It could also drive up prices as large players could end up sharing business to maintain their share of the market.

This non-deposit liability proposal is a significant divergence from the deposit cap that is in place. The non-deposit liability proposal caps growth while the deposit cap does not. The deposit cap does not allow a bank to make an acquisition that would drive the acquiring bank's deposit share above 10%. However, banks are allowed to organically grow beyond the 10% cap. Such a cap allows the banks to compete for share, but makes them do so through expanding existing footprints or developing new businesses. The non-deposit liability cap limits large bank shr to current shr (likely to slow growth).

## BAC, C, & JPM Look Cheap Even if you Split them into IB/Non-IB Businesses

We looked at valuation levels for BAC, C, and JPM by splitting them up into IB and non-IB portions of the companies and analyzing both segments on a price to book basis. This gives a rough assessment of what the IB and non-IB segments of the companies are worth if the IB portion were to be spun-off. See the following exhibit for a list of IB and non-IB comps that we utilized in this analysis. Our analysis utilizes equity allocations as disclosed by the companies to the IB and non-IB.

The low probability risk of splitting into two companies is not a significant concern for our current ratings on the stocks. Why?

- Current PB valuations for the IB and non-IB businesses are pretty similar at 1.1x and 1.2x
- Target valuations are higher for the IBs at 1.6x vs. 1.2x for the banks
- Total company leverage is modest at 10-12.7x for BAC, C, JPM
- JPM will be allocating more capital to its IB, to be announced at analyst day on Feb 25, 2010. Currently at 20x, we estimate it reduces its IB leverage to 12x to be in-line with C and BAC. Non-IB leverage would rise from today's low 10.7x to 13x

**Where could we be wrong?**

- Funding costs. Borrowing costs for the new, stand-alone IBs could be so high that earnings outlooks decline materially for these IB businesses. But, with walls erecting around the IB businesses, there could also be room for widening spreads offsetting some of that higher funding cost.
- Uncertainty. The market doesn't like the uncertainty around industry structure and growth. We expect uncertainty should diminish as we get through 1H10 as the Senate version of the financial services reform bill takes shape and as the Basel committee reviews the feedback from the banks on Basel 3.

Exhibit 1

**Comps:** *Current P/B multiples are 1.2x (IB) and 1.1x (non-IB); Targets are 1.6x (IB) & 1.2x (non-IB)*

| IB Comps | Shr Price | Tgt Price | BVPS | Current P/B | Target P/B |
|---|---|---|---|---|---|
| GS | $154.12 | $221 | $117 | 1.3x | 1.9x |
| MS | $27.80 | $37 | $27 | 1.0x | 1.4x |
| **IB Median** | | | | **1.2x** | **1.6x** |

| Non-IB | Shr Price | Tgt Price | BVPS | Current P/B | Target P/B |
|---|---|---|---|---|---|
| BBT | $28.15 | $33 | $23 | 1.2x | 1.4x |
| FITB | $12.10 | $13 | $12 | 1.0x | 1.0x |
| KEY | $7.25 | $8 | $9 | 0.8x | 0.9x |
| PNC | $53.62 | $73 | $47 | 1.1x | 1.5x |
| RF | $6.60 | $7 | $12 | 0.5x | 0.6x |
| STI | $24.55 | $30 | $35 | 0.7x | 0.9x |
| USB | $24.67 | $29 | $13 | 2.0x | 2.3x |
| WFC | $27.26 | $42 | $20 | 1.4x | 2.1x |
| **Non-IB Median** | | | | **1.1x** | **1.2x** |

Source: Company data, Factset, Morgan Stanley Research. Note: GS & MS target prices based on averages reported by Factset as of 1/22/10; non-IB target prices use MS estimates.

### Analysis #1: What's in Today's Price?

We ran this two ways. First, assume the IBs are correctly valued at a SOTP valuation of 1.2x book. Our analysis shows that current valuation levels imply significantly depressed multiples on the non-IB portions of the banks. We estimate that BAC's bank operations are trading at just 0.3x book value, JPM at 0.9x, and C at 0.2x. While all of these valuations are far too low, in our opinion, we note that JPM should command a higher multiple than the peer average based on its TSS business, while C's lower multiple is likely due to its restructuring and uncertainty surrounding core businesses.

Second we reversed this. Assume the banks are correctly priced at 1.1x non-IB book. The IB portions of these banks are trading at 0.9x for JPM, and 0x for BAC and C.

Exhibit 2

**What's in today's price?** *Assuming the IB portions of these businesses are priced at the industry's 1.2x book value, we est that the bank (non-IB) portions of BAC, C, & JPM are trading at just 0.3x, 0.2x, and 0.9x book value, respectively.*

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| P/B Multiple | 1.2x | **0.3x** | 0.6x | 1.2x | **0.2x** | 0.6x | 1.2x | **0.9x** | 1.0x |
| Value | 99,189 | 48,861 | 148,050 | 75,999 | 16,572 | 92,571 | 64,752 | 89,616 | 154,369 |
| **Per Shr** | **$9.98** | **$4.92** | **$14.90** | **$2.67** | **$0.58** | **$3.25** | **$16.43** | **$22.73** | **$39.16** |

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| P/B Multiple | **-0.1x** | 1.1x | 0.6x | **0.0x** | 1.1x | 0.6x | **0.9x** | 1.1x | 1.0x |
| Value | (6,080) | 154,130 | 148,050 | 416 | 92,155 | 92,571 | 48,028 | 106,341 | 154,369 |
| **Per Shr** | **($0.61)** | **$15.51** | **$14.90** | **$0.01** | **$3.24** | **$3.25** | **$12.18** | **$26.98** | **$39.16** |

Source: Company data, Morgan Stanley Research. Data shown as of 4Q09. Note: BAC equity allocation based on 4Q09 EOP equity. JPM equity allocated to IB includes amt disclosed by company and a comparable portion of unallocated equity. BAC assumes conversion of Common Equivalent Shares.

## Analysis #2: SOTP Valuation Using *Current* IB & Non-IB Comps

By assigning current competitor multiples to both IB and non-IB portions of BAC, C, and JPM, we derive valuations of $25.49, $5.90, and $43.40, implying significant upside to current valuation levels.

Exhibit 3

### SOTP: Market Values Using *Current* Comps Imply Significant Upside to Share Prices

*Using current IB and non-IB comps, we derive SOTP values of $25.49 for BAC, $5.90 for C, and $43.40 for JPM.*

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| P/B Multiple | 1.2x | 1.1x | 1.1x | 1.2x | 1.1x | 1.1x | 1.2x | 1.1x | 1.1x |
| Value | 99,189 | 154,130 | 253,318 | 75,999 | 92,155 | 168,153 | 64,752 | 106,341 | 171,093 |
| **Per Shr** | **$9.98** | **$15.51** | **$25.49** | **$2.67** | **$3.24** | **$5.90** | **$16.43** | **$26.98** | **$43.40** |
| **Upside vs Current Shr Price** | | | **71%** | | | **82%** | | | **11%** |

Source: Company data, Morgan Stanley Research. Note: BAC equity allocation based on 4Q09 EOP equity. JPM equity allocated to IB includes amt disclosed by company and a comparable portion of unallocated equity. BAC assumes conversion of Common Equivalent Shares.

## Analysis #3: SOTP Valuation Using *Target* IB Multiple & *Current* Comp Non-IB Multiple

Valuations based on target comps drive prices of $29 for BAC, $7 for C, and $50 for JPM. This uses 1.6x P/B for the IB and 1.1x P/B for the non-IB portion of the business.

Exhibit 4

### Implied Valuation Using *Target* IB Multiple & *Current* Non-IB Comp Multiple

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| P/B Multiple | 1.6x | 1.1x | 1.3x | 1.6x | 1.1x | 1.3x | 1.6x | 1.1x | 1.3x |
| Value | 137,618 | 154,130 | 291,747 | 105,443 | 92,155 | 197,598 | 89,840 | 106,341 | 196,180 |
| **Per Shr** | **$13.85** | **$15.51** | **$29.36** | **$3.70** | **$3.24** | **$6.94** | **$22.79** | **$26.98** | **$49.77** |
| **Upside vs Current Shr Price** | | | **97%** | | | **113%** | | | **27%** |

Source: Company data, Morgan Stanley Research. Note: BAC equity allocation based on 4Q09 EOP equity. JPM equity allocated to IB includes amt disclosed by company and a comparable portion of unallocated equity. BAC assumes conversion of Common Equivalent Shares.

## Analysis #4: Valuation Using Comp *Target* Multiples for *both* the IB and Non-IB

The exhibit below shows valuation for the three companies based on the target p/b multiples for comparable investment bank and non-investment banks. This yields valuations of $32 for BAC, $7.50 for C, and $54 for JPM.

Exhibit 5

### Valuation Using Target IB & Target Non-IB Multiples

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| P/B Multiple | 1.6x | 1.2x | 1.4x | 1.6x | 1.2x | 1.4x | 1.6x | 1.2x | 1.4x |
| Value | 137,618 | 179,562 | 317,179 | 105,443 | 107,361 | 212,804 | 89,840 | 123,888 | 213,727 |
| **Per Shr** | **$13.85** | **$18.07** | **$31.92** | **$3.70** | **$3.77** | **$7.47** | **$22.79** | **$31.43** | **$54.22** |
| **Upside vs Current Shr Price** | | | **114%** | | | **130%** | | | **38%** |

Source: Company data, Morgan Stanley Research. Note: BAC equity allocation based on 4Q09 EOP equity. JPM equity allocated to IB includes amt disclosed by company and a comparable portion of unallocated equity. BAC assumes conversion of Common Equivalent Shares.

### Analysis #5: Valuation of Non-IB Required to Reach our Target Prices

Using the current IB multiples, we determine what the market would have to value the remaining non-IB portion of each company in order to get to our target prices. We estimate that the market would have to place a 1.2x p/b multiple on the non-IB portion of BAC in-line with our target multiple for the bank group, 0.9x C, and 1.7x JPM. We view these multiples as reasonable given the business models of the three firms, the restructuring that C faces, and JPM's Asset Management and TSS businesses commanding a premium multiple to a banking multiple.

Exhibit 6

**Valuation of Non-IB Required to Reach our Target Prices, assuming IB P/B at 1.2x**

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| P/B Multiple | 1.2x | **1.2x** | 1.2x | 1.2x | **0.9x** | 1.0x | 1.2x | **1.7x** | 1.5x |
| Value | 99,189 | 179,026 | 278,215 | 75,999 | 80,660 | 156,658 | 64,752 | 167,826 | 232,578 |
| **Per Shr** | **$9.98** | **$18.02** | **$28.00** | **$2.67** | **$2.83** | **$5.50** | **$16.43** | **$42.57** | **$59.00** |
| **Upside vs Current Shr Price** | | | **88%** | | | **69%** | | | **51%** |

Source: Company data, Morgan Stanley Research. Note: BAC equity allocation based on 4Q09 EOP equity. JPM equity allocated to IB includes amt disclosed by company and a comparable portion of unallocated equity. BAC assumes conversion of Common Equivalent Shares.

### What About Leverage? IBs Look Adequately Capitalized

Since the stocks look cheap on many of these analyses, it appears the market may be concerned about whether or not there is sufficient capital on a standalone basis. Our basic analysis suggests that even if the IBs were spun out of BAC, C, and JPM, the remaining operations would only be levered 9.4x – 13.1x. BAC has the lowest leverage in the group at 10.5x. In addition, leverage at the IB segments seems on the low end of the peer range (leverage at stand-alone IBs is currently in the 12-15x range).

Exhibit 7

**Current Leverage Ratios:** *Leverage ratios low at 10.5-12.7x*

| | BAC | | | C | | | JPM | | |
|---|---|---|---|---|---|---|---|---|---|
| ($ millions) | IB | Non-IB | Total Co | IB | Non-IB | Total Co | IB | Non-IB | Total Co |
| Assets | 1,044,966 | 1,376,565 | 2,421,531 | 796,000 | 1,060,200 | 1,856,200 | 674,241 | 1,318,984 | 1,993,225 |
| Equity | 85,079 | 146,365 | 231,444 | 65,188 | 87,512 | 152,700 | 55,541 | 100,984 | 156,525 |
| Leverage | 12.3x | 9.4x | 10.5x | 12.2x | 12.1x | 12.2x | 12.1x | 13.1x | 12.7x |

Source: Company data, Morgan Stanley Research. Note: BAC equity allocation based on 4Q09 EOP equity. JPM equity allocated to IB includes amt disclosed by company and a comparable portion of unallocated equity.

### JPM Leverage

At first glance (based on co disclosures), JPM's investment bank appears to be 20.4x levered, while the non-IB is just 10.7x levered. However, we note that equity allocated to the corporate/other category is a large 40% of total equity. We expect JPM will redistribute some of this to the IB as they outlined on their earnings call. We model that JPM redistributes sufficient equity for the IB to be levered at a 12.1x leverage ratio (in line with peer range), and the non-IB is 13.1x levered.

Exhibit 8

**JPM Leverage:** *100% Allocation of Equity Derives Stronger Leverage Ratios*

| | Equity Allocation | | Leverage | |
|---|---|---|---|---|
| ($ millions) | Current | Adjusted | Current | Adjusted |
| IB | 33,000 | 55,541 | 20.4x | 12.1x |
| Non-IB | 123,525 | 100,984 | 10.7x | 13.1x |
| Total Co | 156,525 | 156,525 | 12.7x | 12.7x |
| *Unallocated* | *63,525* | *0* | | |

Source: Company data, Morgan Stanley Research. Unallocated equity refers to co disclosure for Corporate/PE allocated equity.

### Obama/Volcker Sensitivity Analysis

In our January 21, 2010 note "Obama/Volcker Proposal Another Possible Ding on Bank EPS," we ran a sensitivity analysis around the potential impact of the proposal on normalized bank earnings and our target prices. The exhibit below recaps our analysis.

Exhibit 9

**Sensitivity Analysis to Prop Trading/PE/HF**

Potential 2012 Impact

| Prop Trading Sensitivit | BAC | C | JPM |
|---|---|---|---|
| Prop 5% of Trading | $0.03 | $0.01 | $0.07 |
| Prop 10% of Trading | $0.07 | $0.01 | $0.14 |
| Prop 15% of Trading | $0.10 | $0.02 | $0.21 |
| **Total EPS Impact** | **BAC** | **C** | **JPM** |
| Prop 5% of Trading | $0.11 | $0.01 | $0.19 |
| Prop 10% of Trading | $0.14 | $0.01 | $0.26 |
| Prop 15% of Trading | $0.17 | $0.02 | $0.33 |
| **As % of EPS** | **BAC** | **C** | **JPM** |
| Prop 5% of Trading | 3% | 2% | 3% |
| Prop 10% of Trading | 4% | 3% | 4% |
| Prop 15% of Trading | 5% | 5% | 5% |
| **Impact to Share Price** | **BAC** | **C** | **JPM** |
| Prop 5% of Trading | ($1.09) | ($0.07) | ($1.89) |
| Prop 10% of Trading | ($1.42) | ($0.14) | ($2.57) |
| Prop 15% of Trading | ($1.74) | ($0.21) | ($3.25) |

Source: Company data, Morgan Stanley Research

### Valuation and Risks

Our price targets are based on residual income valuation, using a normalized beta and cost of equity capital. We expect that the market will start to value banks off of longer-term, normalized earnings as nonperforming loans peak out, likely in 1H10. Our bull case intrinsic values use residual income valuation and our bear case intrinsic values are based on 2010, bottom-of-cycle, bear case, price-to-tangible book, assuming all non-government preferred is converted to common shares. We assume a 5.5% risk-free rate and a 4.5% equity market risk premium.

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*(as of December 31, 2009)*

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| | Coverage Universe | | Investment Banking Clients (IBC) | | |
|---|---|---|---|---|---|
| Stock Rating Category | Count | % of Total | Count | % of Total IBC | % of Rating Category |
| **Overweight/Buy** | **953** | **39%** | **286** | **41%** | **30%** |
| **Equal-weight/Hold** | **1093** | **45%** | **322** | **46%** | **29%** |
| **Not-Rated/Hold** | **23** | **1%** | **3** | **0%** | **13%** |
| **Underweight/Sell** | **376** | **15%** | **82** | **12%** | **22%** |
| **Total** | **2,445** | | **693** | | |

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Equal-weight (E). The stock's total return is expected to be in line with the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Not-Rated (NR). Currently the analyst does not have adequate conviction about the stock's total return relative to the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Underweight (U). The stock's total return is expected to be below the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

### Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.
Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.
Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.
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## Industry Coverage:Banking - Large Cap Banks

| Company (Ticker) | Rating (as of) | Price* (01/22/2010) |
|---|---|---|
| **Betsy L. Graseck, CFA** | | |
| American Express Company (AXP.N) | O (11/23/2009) | $38.59 |
| BB&T Corporation (BBT.N) | E (10/05/2007) | $28.15 |
| Bank of America (BAC.N) | O (05/07/2009) | $14.9 |
| Bank of New York Mellon Corp (BK.N) | O (04/13/2006) | $29.27 |
| Capital One Financial Corporation (COF.N) | E (11/23/2009) | $37.53 |
| Citigroup Inc. (C.N) | E (07/24/2008) | $3.25 |
| Fifth Third Bancorp (FITB.O) | E (07/10/2008) | $12.1 |
| J.P.Morgan Chase & Co. (JPM.N) | O (12/11/2006) | $39.16 |
| KeyCorp (KEY.N) | E (08/07/2009) | $7.25 |
| Northern Trust Corp. (NTRS.O) | O (10/31/2007) | $52.07 |
| PNC Financial Services (PNC.N) | O (10/31/2005) | $53.62 |
| Regions Financial Corp (RF.N) | U (11/21/2008) | $6.6 |
| State Street Corporation (STT.N) | E (04/26/2009) | $43.36 |
| SunTrust (STI.N) | E (10/30/2009) | $24.55 |
| U.S. Bancorp (USB.N) | E (12/02/2002) | $24.67 |
| Wells Fargo & Co. (WFC.N) | O (10/16/2008) | $27.26 |
| **Cheryl M. Pate, CFA** | | |
| Boston Private Financial Holdings, Inc. (BPFH.O) | E (11/21/2008) | $7.14 |
| Wilmington Trust Corporation (WL.N) | E (11/21/2008) | $14.52 |

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* Historical prices are not split adjusted.