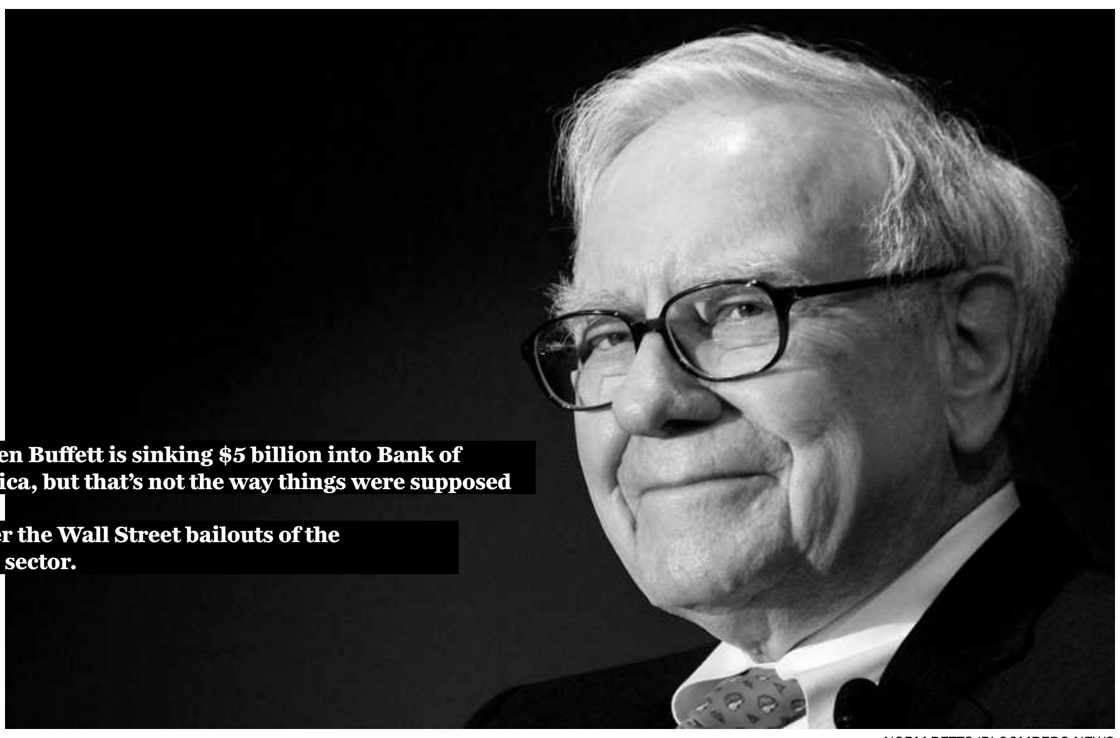
ON THE MONEY



Warren Buffett is sinking $5 billion into Bank of America, but that's not the way things were supposed to go after the Wall Street bailouts of the financial sector.

NORM BETTS/BLOOMBERG NEWS

Stop throwing money at the problem

BARRY RITHOLTZ

On Investing

For anyone who thought the U.S. banking sector was healthy, Warren Buffett's $5 billion investment in Bank of America should be a wake-up call.

Many investors assumed the Wall Street bailouts of Bank of America and the other big banks more or less healed the sector. All it took was few trillion dollars in liquidity and a few $100 billion in recapitalization. Voila!

In fact, the banking system was not saved. The massive injections of liquidity temporarily salved the day-to-day operations of banks, but they did not repair the more profound troubles. Indeed, pouring billions into nearly identical management teams that mismanaged risk, overleveraged exposure and drove banks off the cliff in the first place was an invitation for another crisis.

In past weeks, Bank of America has been under increasing pressure from investors. Its already damaged stock was cut in half, and commentators including myself argued that the bank was headed back toward the rocky shoals of insolvency.

On Thursday, Buffett stepped in, at least temporarily, to save Bank of America's bacon. He was inspired, Archimedes-like, in the bathtub — an image I will likely carry with me for the rest of my days.

Buffett has put together a deal on terms similar to those he offered Goldman Sachs and General Electric: A fat 6 percent yield on preferred (not common) stock, and warrants to buy 700 million Bank of America shares at $7.14 each, good for 10 years.

A few items leapt out:

● Despite its repeated claims to the contrary, Bank of America needed both capital and a reputation reboot. Buffett provided a little of both, though I'm not sure which they needed more.

● With the Fed offering banks capital at nearly zero percent interest rates, why would BofA take money at 6 percent? This gives lie to the claim that BofA did not need more capital. (The counterargument is this was about the stock slide, not the capital structure, which remains opaque.)

● Investors are cautioned that unless you are buying on the same terms as the billionaire, you are making a very different bet than he is.

But all of this goes back to the failures of the 2008-09 bailouts. Consider what was actually done then, and you will understand why none of the underlying problems have been fixed:

● **Bank holdings:** They remain stuffed with declining assets, primarily in housing and derivative holdings. Another leg down in housing could be nearly fatal.

● **Transparency:** Balance sheets are unnecessarily opaque. Eliminating fair-value accounting via FASB 157 did not fix balance-sheet problems, but instead allowed banks to hide them.

● **Capitalization:** This remains too thin. Leverage should be mandated back to the pre-2005 rule change of no more than 12 to 1. Management does not keep adequate capital unless forced to do so ("sufficient" capital reserves cuts into profits).

● **Misaligned incentives:** Compensation and bonus schemes were not significantly changed after the bailouts, except during loan repayments. Thus, management and traders still have the same upside to roll the dice, but they do not have the downside risks, which remains on shareholders and taxpayers.

Imagine: What if we'd gone Swedish on banks like Citi and BofA — nationalize 'em, clean 'em up, spin them back out to the markets by placing them into a prepackaged reorganization (a polite phrase for bankruptcy). Here's how that might have played out:

First, the easy stuff: Fire senior management. Not just the chief executive. Nearly the entire top floor at the bank, including the board of directors, is canned. Equity shareholders are wiped out. Whatever is left after all is said and done goes to the bondholders, typically, at 25 to 50 cents on the dollar. (In Sweden, bondholders got 100 cents on the krona, but that currency was significantly devalued. So the bondholders were not made whole; they lost 50 to 75 percent in real value.)

Temporary nationalization is the play: Uncle Sam provides debtor-in-possession financing to keep operating. All of the bad holdings, mortgages, derivatives and other liabilities are pulled out and auctioned off. This includes the bad real estate (REOs), the CDS/CDO book, defaulted mortgage obligations. Remember, there are no such thing as toxic assets, only toxic prices. At some valuation, these are worthwhile investments — just not 100 cents on the dollar. Let healthy buyers pay 15 to 30 cents. And anything that is worthless gets written down to zero.

Recapitalize the parent bank, and spin off each division: IPO Merrill Lynch for $20 billion. Spin out a clean Countrywide for maybe $8 billion. Sell off all the non-depository bank pieces.

What you have left is a well-capitalized bank, owned by taxpayers, with well-capitalized divisions as stand-alone companies. All of the above have transparent balance sheets. Eventually, everything gets IPO'd back to the public markets. Uncle Sam gets repaid, and whatever is left (if anything) goes to the bondholders.

You would have also created a transparent, unleveraged, adequately capitalized banking system that would be a contributing member of the U.S. economy, rather than zombie banks that don't realize they are already dead.

But all that was a missed opportunity — for W and O alike. What we have instead is banking behemoths that apparently still require extraordinary intervention (a.k.a. life support). Many of these remain mortally wounded by holdings that would have been shed in any type of reorganization.

I suspect that the downturn in the sector is a credible bet that these banks are not in any condition to withstand a recession. If the banks come crawling back to Uncle Sam for another bailout, it will be proof that "rescuing" financial institutions that blow themselves up is the wrong strategy.

Real capitalists know failure is part of the process. We may well have another chance to fix the banking system. Let's hope we do it right this time.

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STEVEN PEARLSTEIN

Time to say no to bank consolidation

PEARLSTEIN FROM G1

more trillion-dollar banks in five years.

Taking the lead are two banks well known to Washingtonians — Capital One, which has struck a deal to buy online savings bank ING, and PNC, which has a deal to buy the U.S. operations of the Royal Bank of Canada. Both acquisitions would create banks with roughly $300 billion in assets supporting a wide range of financial services that will get even wider when boom times return.

Because it is the earlier and bigger of the deals, and involves one of the largest and most successful credit card companies, Capital One's acquisition of ING is likely to set a precedent under Dodd-Frank, which for the first time requires the Federal Reserve to consider impact of a merger on the stability of the financial system. To its credit, the Fed on Friday took the unusual step of scheduling public hearings on the issue.

The Capital One-ING review also comes as a new council of financial regulators considers whether to designate large insurers, asset managers and finance companies as "systemically important," subjecting them to closer scrutiny and higher capital standards. The indications are that, other than possibly AIG, none will be designated.

Recall that when Republicans united to oppose Dodd-Frank, they justified it on the basis of their deep concern that not enough was done to deal with the banks that were "too big to fail." How strange, then, that not a single Republican has questioned the Capital One and PNC deals. Instead, it has fallen to Democrat Barney Frank, who is intent on seeing the law that bears his name is enforced.

Capital One is a big deal in the Washington regional economy. It is a big employer, an admirable corporate citizen and, under its founder Richard Fairbank, a great entrepreneurial success story. It has grown from its roots in the credit card business to what it hopes will be the country's fifth-largest bank as well, thanks in part to the purchase of Bethesda-based Chevy Chase Bank. By staying away from shoddy mortgage lending, derivatives trading and investments in mortgage-backed securities, Capital One is the rare large financial institution that never reported an unprofitable year through the financial crisis, despite charge-off rates on credit card loans that at one point reached nearly 10 percent.

Today, Capital One is an efficient and profitable machine that sucks up deposits from a vast network of ATMs and bank branches, then lends them at an interest rate spread of 7 percentage points to consumers and credit card holders using highly sophisticated computerized underwriting. That machine will only become more efficient with the purchase of ING, with its $80 billion in deposits, particularly after Capital One completes its acquisition of the $30 billion U.S. credit card portfolio of London-based HSBC.

Unlike some of its critics, I'm not overly concerned that Capital One neglects minority borrowers, at least when compared to other banks. Its Community Reinvestment Act rating has been outstanding and is expected to remain so at the next reporting.

What does concern me, however, is that even more of the nation's bank deposits will be channeled to small businesses through corporate credit cards rather than through loans made by flesh-and-blood bankers. Why is that important? Simply put, because only bankers with deep understanding of industries, communities and customers can be relied on not to push cheap and easy loans during credit booms and then abruptly cut off credit lines or raise rates at the first sign of economic trouble.

Despite their denials, what I just described is the model for business lending for credit card companies such as Capital One. Over the years it has systematically undermined traditional business lending by community banks while exacerbating the swings in the credit cycle and the economy. That is particularly true here in Washington, where Chevy Chase Bank has never been a factor in business lending outside of real estate, in large part because of the limitations of its savings bank charter.

My second concern is that Capital One, along with the rest of the banking industry, is proposing criteria for assessing risks to the financial system so narrowly that they wind up never stopping any financial institution from doing anything. By trying to come up with purely objective, numeric criteria for determining what size is "too big" or what businesses are "too risky," regulators fall into a trap in which any acquisition or activity can made to appear too insignificant to trigger a global financial crisis.

Remember Fed chairmen Alan Greenspan and Ben Bernanke assuring everyone that subprime mortgage lending was just too small to cause a financial crisis? That is precisely the kind of reasoning that develops when regulators take the narrow, numeric view.

By such standards, regulators in 2007 would have surely concluded that Bear Stearns was not "systemically important." And yet when Bear was in danger of collapse, Bernanke and his Fed colleagues concluded that they had no choice but to mount a rescue. Why? According to their own testimony, because they feared a psychological impact that would trigger a run on the financial system.

Consider firms that are systemically important in the way Bear Stearns was. Capital One has assets of $300 billion. BlackRock holds $3.7 trillion worth of other people's assets. And GE Capital at one point had half a trillion dollars in outstanding corporate and commercial real estate loans. All are big and blue-chip enough that the failure of any would cause even lenders and investors not associated with them to run for the exits.

The truth is that there is no great social or economic benefit to Capital One buying ING. Smaller institutions could buy ING, albeit for a lower price. Or it could be spun off to existing shareholders as a strong, independent company. Even without a merger, ING customers can freely get loans from Capital One while Capital One customers are free to deposit their money online with ING. Whatever efficiency gains there are from this acquisition are likely to be captured by shareholders, not customers.

And while it is true that there is a big difference between the systemic risks posed by a trillion-dollar bank and a $300 billion bank, that kind of logic falls into the category of two wrongs somehow making a right. We know that Greenspan and fellow regulators should never have permitted mergers that created trillion-dollar banks. Given the recent crisis, using that as the standard is loony.

Bank consolidation is like a drug — the more you do, the more you want to do. At some point the rest of us have to do the Nancy Reagan thing and just say no.

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Beaten-down small-cap stocks could be ready to rally, some say

INVEST FROM G1

among professional investors.

"If we're not in an economic recession, we could see a decent rally in small-cap stocks," said Steven DeSanctis, small-cap strategist at Bank of America Merrill Lynch in New York.

Small-cap stocks have lost so much value this year — about 25 percent since their late-April peak, as measured by the small-cap Russell 2000 index — that DeSanctis thinks "flat is the new up": If they simply end the year where they started, investors will see about a 13 percent rally from where they are now. Large-cap stocks slid about 18 percent in the same period.

Bank of America sees a 40 percent chance of recession, he added.

"That's really the question that people have to answer for themselves — 'Do we think a recession will occur?' " said Mathew Litfin, a portfolio manager at William Blair who invests in small- and mid-size companies.

Economists have grappled with that possibility in recent weeks. In late July, the Commerce Department said the economy grew at snail's pace of 1.3 percent in the second quarter and revised its first-quarter estimates to 0.4 percent. A spate of weak reports on manufacturing followed. Then came gloomy figures on housing and consumer spending. And Friday, Commerce revised the second-quarter growth number down to 1 percent.

Not surprisingly, many economists say the odds of recession increased significantly in the past three months. But few are ready to call it — and therein lies the opportunity, experts say, for some diversification into small-cap stocks, best accessed through mutual funds.

Small firms tend to get hit much harder than big ones during economic downturns because they often have less diversified businesses and less cash on hand. That, in turn, gives banks second thoughts about lending them money, which can slow their growth even more.

"It's very hard for them to get credit and capital," said Chris Hanaway, portfolio manager at Wells Fargo Advisors. "If we go into another global recession, they will suffer disproportionately."

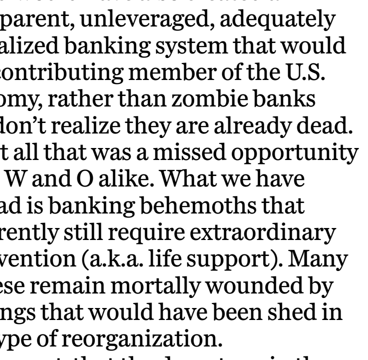
The opposite is true in good times. Small companies tend to be at an earlier stage of growth than their bigger counterparts. "It's the law of large numbers," said Gary Lenhoff, director of small- cap strategy at Great Lakes Advisors. "It's harder for IBM or Microsoft to grow as fast — they already have revenues measured in the billions."

So when money's pouring in, small companies can plow it back into their business by buying equipment, opening stores or acquiring customers that move the needle on their performance more than similar actions by larger companies can.

"That indeed is borne out by the data over the last 83 years," said Jay Ritter, finance professor at the University of Florida. From 1927 to 2010, small companies beat large ones by an average of about 0.36 percent a month when the economy was expanding, Ritter said. In downturns, they underperformed their larger peers by about 0.2 percent a month.

Money makers

The Russell 2000, which tracks small-cap firms, had a bigger rebound that the Russell 1000's larger firms



Source: CS Small/Mid Cap US Equity Strategy, Haver THE WASHINGTON POST

The nuance, Ritter said, is that not all small-cap stocks are created equal. Those classified as "growth" investments — companies that are rapidly expanding but have yet to pay out steady dividends — tend to be "a triumph of hope over experience" because they ultimately deliver disappointing returns, he said.

That isn't commonly the message one finds in newsletters dedicated to the small-cap sector.

"Technological advancements periodically come along that exert a profound influence on not only the business world but also society as a whole," said a recent issue of Cabot Small-Cap Confidential, a Massachusetts-based newsletter, when it recommended a "big opportunity" to buy Digi International, a small-cap firm that develops communication technology.

"Newsletters like to tout the next Microsoft," Ritter said, but "Microsoft was never a small-cap stock," and it is extremely rare for small-cap growth stocks to grow into corporate behemoths. Far more common is for small-cap "value" stocks — those whose business models are proven enough that they can consistently pay out money to their shareholders — to deliver solid returns.

Wetherell uses dividend initiations as one proxy for differentiating between growth and value plays. In January, after Lincoln Educational Services, a for-profit college, initiated a 25-cent dividend, his fund swooped in to buy 8,000 shares. With the recent meltdown, the company's shares tumbled 50 percent, to $9, meaning it is now paying out an annual dividend of more than 10 percent. The 10-year Treasury bond is paying about 2 percent.

"We tend to like plays that are out of favor," Wetherell said, so he's holding on to the company.

Others find small-cap investment strategies, well, laughable.

"They really got creamed!" said Timothy Loughran, who teaches stock valuation at the University of Notre Dame. He chuckled when he looked at a stock chart for Lincoln Educational Services. "I just don't think small firms are the way to go."

Loughran thinks investors should set aside the question about a recession and focus more on which emotions will drive the market in the near future.

"I think the market is more likely to continue the flight to quality," he said, which means large-cap companies like Apple and Google are likely to see more demand for their shares than small-caps. "They're established, they have lots of product lines, and — most importantly — they have huge amounts of cash on hand."

DeSanctis, the small-cap strategist at Bank of America Merrill Lynch, concedes that large-cap companies are likely to beat their small-cap counterparts next year because slow economic growth is likely to translate to weak earnings growth — recession or not.

In January, Lori Calvasina, who researches small-cap stocks at Credit Suisse, warned clients to think twice about allocating more money to the sector because small-caps' valuation relative to large-caps was at a 30-year high. "I've basically been the 'negative Nellie' all this year, irritating my clients," she said.

Now, "I'm getting more interested in the sector," she said, but "I'm not pounding the table by any stretch."

Why not?

"They've fallen, but they're not cheap, yet," she said. "And that's annoying."

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