Time to Buy Financial Stocks?

Some brave long-term investors are looking for bargains among the casualties of the credit crunch

by Ben Steverman

For stock investors, recent action in the financial sector has seemed like one of those theme-park haunted-house rides. Ghouls routinely pop out from the dark at every turn, scaring again and again with credit losses, mortgage defaults, market disruptions, and billion-dollar hits to the balance sheet. The most frightening thing: No one knows how long the ride will last.

Yet some investors say such terrifying conditions are a great time to start buying stock in the financial sector.

Their argument: Financial stocks in the S&P 500 have tumbled almost 10% in the last six months, while the broader index is up 2.75%. Financial giants like Citigroup (C), Bank of America (BAC), Wachovia (WB), Merrill Lynch (MER), and big insurer AIG (AIG) are all trading at or just above one- and, in some cases, two-year lows.

Company (Ticker)	Price (10/29/07)	Change
AIG (AIG)	$63.02	1.4%
Bank of America (BAC)	$47.89	–0.3%
Citigroup (C)	$42.55	–0.2%
Goldman Sachs (GS)	$239.28	1.4%
JPMorgan (JPM)	$46.68	–1.4%
Lehman Brothers (LEH)	$61.92	2.5%
Merrill Lynch (MER)	$66.00	–0.1%
Morgan Stanley (MS)	$65.75	1.5%
Wachovia (WB)	$46.49	–0.1%
Wells Fargo (WFC)	$34.33	–0.6%

For long-term investors, the beat-up financial sector may be the best place to look for bargains. The shares of some regional banks, in particular, are at levels that basically price in a "worst-case scenario" of a recession, says William Fitzpatrick, an equity analyst at Johnson Asset Management. Many banks are paying big dividends of 7% or 8%. On "any sort of recovery at all, these stocks are really going to rally," he says.

But Fitzpatrick and other expert investors warn that financial stocks are at low prices for very good reasons. Things really could go from bad to even worse.

The recent troubles at Merrill Lynch give an idea. At first, the U.S.'s largest brokerage said it expected $5.5 billion in losses in the quarter from losses in mortgage-backed debt and other credit troubles. Less than a month later, that number was up to almost $8 billion.

"When there's that much change in a few weeks, it just shows the complexity of these instruments, and that they were getting involved in areas they didn't understand," says Alan Lancz of the research firm Lancz Global.

If it's tough for even company insiders to understand the impact of the summer's credit disruptions, it's that much harder for the average investor.

Still, some hope that a lot of the damage out there has already been reported. "I think most of the firms parked all the bad news in their third-quarter earnings," says Scott Armiger, portfolio manager at Christiana Bank & Trust Company (CBTD). They had every incentive to get all or most of the bad news out of the way.

In the third quarter, Reuters Estimates predicts earnings for the financial sector fell 17%. Analysts surveyed expect a modest 3% increase in the fourth quarter.

However, the big brokerage firms, including Goldman Sachs (GS), Lehman Brothers (LEH), and Bear Stearns (BSC), report on a different calendar that didn't include September in the third quarter. That raises the chance for more surprises from the big Wall Street firms, Fitzpatrick says. "There are definitely more shoes to drop there," he says.

But the threat of bad news in the next quarter or two doesn't bother investors who are in it for the long haul. They're less concerned about the fourth quarter than about the next year and beyond.

Yet here, too, there's plenty to worry about. Millions of homeowners will see their mortgages reset to higher interest rates in 2008 and 2009. Plus, home prices keep falling. Both factors could make it much tougher for Americans to pay off debt of all forms, a trend already showing up in the rising number of delinquencies and defaults at banks.

The biggest worry may be a recession in the U.S., which economists peg as a possibility but not a likelihood. Many financial issues can be managed, Armiger says, "But there's a problem if we do sink into a recession."

Still, there are a few positive signs. Many big financial institutions are seeing plenty of growth in large parts of their business despite weakness in credit products.

"Once you get past the question of how much exposure they have to subprime or credit derivatives, the underlying enterprise is sound" at many players, says Eric Boyce, portfolio manager at Hester Capital Management.

Big Wall Street firms like Lehman Brothers and Goldman Sachs have large, and rapidly growing, international operations, for example. "A U.S. slowdown is not going to bring them to their knees," Boyce says.

Banks can also benefit from lower interest rates as the Federal Reserve tries to prevent an economic slowdown.

Finally, stock prices in the group are so low already that they may not have much further to fall. With prices this low, many analysts are spotting great buyout candidates. The one problem is that potential acquirers should be worried about what kind of toxic debt is hidden on balance sheets.

As always, it's worth picking and choosing your buys in the financial sector. Along with considering stock price and dividends, look at how well the firm managed the recent financial crisis. Armiger gives JPMorgan (JPM) and Wells Fargo (WFC) high marks, for example, while saying Citigroup and Bank of America fell short.

Boyce, however, owns Citigroup because it has a great brand name and a broad reach and is trading at a bargain price. "It's a good time [to buy] if you have the temperament and patience to wait," Boyce says.

In other words, don't expect to make a quick buck off financial stocks, and be ready for a long -- and possibly terrifying -- ride ahead before the goblins make their exit.