The Carnage for Financials Isn't Over

By Michael Markowski

The carnage for the financials isn't over. In a previous article for *EQUITIES* (September 2007's "Have Wall Street's Brokers Been Pigging Out?"), I recommended that my readers get out of all-brokerage stocks and also stated, "I believe that there will be a day of reckoning… and that day will be ugly for the five largest brokers."

Obviously that day came on Sept. 15, 2008, when Lehman filed for bankruptcy and the once formidable Merrill Lynch agreed to be acquired by Bank of America. What will happen now to the United States' two remaining brokers, Morgan Stanley and Goldman Sachs?

In my January 2008 follow-up article, "Brokerages and the Subprime Crash," I predicted that more was to come on the downside, that Merrill Lynch shares were destined to trade at less than $30, and that Goldman Sachs shares would most likely fall below $100 before the carnage was over. Merrill shares were at $53 and Goldman Sachs shares were at $216 at that time. This prediction was based on the fact that the all-time record string of earnings reported by brokers between 1999 and 2006 were supported by the dot-com and housing bubbles.

My argument was that, without the formation of new bubbles, it would be very difficult for brokers' earnings to not return to the norm. If that happened, the shares of all, including Merrill and Goldman, would likely decline significantly. The only thing that has changed since my January 2008 update is that the global liquidity crisis and housing declines are not over. This does not bode well for the two remaining brokers because the debt markets will soon be flooded with the debt securities that were previously held by Lehman, Freddie Mac, and Fannie Mae.

This will likely cause markdowns on the balance sheets of both Goldman Sachs and Morgan Stanley and will further erode their ratios of tangible book over total liabilities. The bottom line is that the bad news—due to the markdowns of assets and the risk for their shareholders—will be increasing. I expect that the shares for both to trade significantly lower.

The crisis will soon start spreading to other previously unaffected areas, including the asset management industry. That is why I would avoid the industry, specifically mutual fund juggernaut **Franklin Resources (NYSE: BEN)** and **Eaton Vance (NYSE: EV)**.

Franklin Resources has experienced a double-digit decline in annualized cash flow from operations and free cash flow for its last three consecutive quarters. The last time Franklin had three or more consecutive quarters of negative cash flow was back in 2004, with its shares trading at $55.

Eaton Vance's cash flows have also been heading down for its last two consecutive quarters and look downright ugly with a decline of 35.9% and 37.8%, respectively, for CFFO and FCF for its 12 months ended July 31, 2008.

Shares of companies exposed to the asset management industry will soon begin to decline for three main reasons. The first is the price declines for equities in all global stock markets due to the credit storm. The second is a new secular trend, just underway, where baby boomers are now beginning to liquidate or live off of their IRA and 401(k). The third reason is that the first wave of baby boomers is now over 60 years old, and their appetite for risk and stocks is going to go down while their appetite for bonds and debt goes up.

This is bad news for the asset management industry because they generally charge significantly higher fees to manage equity or stock portfolios than they do for debt or bond portfolios. Asset managers—including hedge funds, mutual funds, and registered investment advisors—all get a fixed percentage fee on the assets that they are managing. If the assets go up in value, their fee goes up, and vice versa. It's the vice versa that shareholders of asset management companies should be worried about because fees are definitely going to go down.

That means earnings will most likely decline for the asset management industry when their 2008 numbers are compared against their 2007 numbers. I believe that 2007 could prove to be the peak earnings year in the industry for years to come. **E**

Brokerage Firms Recommended to be Sold by Markowski (September 2007)

Name	Sep. 2007 price	Sep. 2008 price	%Decline
Goldman Sachs	$193.30	$135.50	29.90
Merrill Lynch	$78.17	$17.06	78.18
Bear Stearns*	$121.12	$10.00	91.74
Morgan Stanley	$65.39	$32.19	50.77
Lehman Holdings	$64.78	$00.21	99.68

Acquired by JPMorgan

Michael Markowski is the founder of StockDiagnostics.com, which publishes current and historical cash-flow metrics on over 8,000 companies.

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