

Have Wall Street's Brokers Been Pigging Out?

Debt and negative cash flow may be a serious problem for Wall Street's five largest brokers.



BY MICHAEL MARKOWSKI

I've been following the recent liquidity crisis, which has been caused by the problems with subprime mortgages. Given that Wall Street's big five brokers — Merrill Lynch, Goldman Sachs, Lehman Brothers Holdings, Morgan Stanley, Bear Stearns — and many of the world's bankers have exposure to mortgages and mortgage-backed securities, I decided to do some research on this problem and how it could affect the stock market.

First of all, let me explain that one shouldn't use cash flow from operations (CFO) as the primary metric to analyze financial companies. Financial companies report their financials differently than companies in the service or manufacturing sectors. For example, they don't have receivables and inventory. Comparing results of financial companies and results of non-financial companies is like comparing apples and oranges. Also, there shouldn't be a need to determine the earnings quality of a financial company by analyzing its cash flow, because the earnings are supposedly based on the return on its liquid assets. For example, a bank doesn't sell a product or service. It makes money on the difference in the rate it pays to bor-

row and lend money.

Given the differences in financial and non-financial companies, StockDiagnostics.com focuses on providing its subscribers with charts, data, and information on 8,000 non-financial companies and their related 216 industries. It uses cash flow to determine the quality of earnings. StockDiagnostics.com provides the same cash flow data and charts on 2000 financial companies and several industries.

Even though I focus on non-financial companies, I've been keeping a wary eye on financial companies, particularly on publicly traded brokers, for some time. Recently, some of the largest brokers have been consistently generating negative cash flow. Negative cash flow for a broker isn't, in itself, a major concern because that negative cash flow is being used to make investments on the asset side of their balance sheets. My concern is with the amount of negative cash flow and the consistency at which it is generated.

For example, Lehman Holdings (NYSE: LEH), one of the five biggest brokers in the US, has generated negative cash flow in 13 of its last 15 quarters. In the five quarters before its last 15, it generated positive cash flow in all but one of them. The negative cash

flow of \$42.0 billion generated over its latest 12 months exceed its current market cap of \$34.3 billion. Goldman Sachs (NYSE: GS) has generated negative cash flow for its last six consecutive quarters and positive cash flow in only four of its last 20 quarters.

While I'm sure that Lehman and Goldman can justify their negative cash flow, that isn't really the issue. The issue is that Goldman generated \$31 billion of negative cash flow for its second quarter, which ended May 31, 2007. This means that they had to be using that cash to invest in something. Unless it was US government treasuries, the odds are that the value of that something had to be marked or written down, especially if the debt or equity markets entered an extremely volatile phase. And they have.

There's no way that these five brokers can continue to relentlessly purchase billions of assets and create billions of negative cash flow quarter after quarter. I believe that there will be a day of reckoning. It will be sooner rather than later, and that day will be ugly for the five largest brokers. An obvious question is: Just how many regular, humongous buyers are there for the billions of dollars of the mortgage-backed and private equity-related securities that Goldman and the

Price and Cash Flow Data for Biggest Brokerage Firms

Name	Symbol	Price	10 yr high	Date of high	10 yr low	Date of low	Market Cap	Annual cash flow
Goldman Sachs*	GS	193.30	233.97	05/31/07	55.19	08/10/99	78.0 B	-58.0 B
Merrill Lynch	MER	78.17	98.68	01/18/07	17.88	10/08/98	67.1 B	-64.0 B
Bear Stearns	BSC	121.12	172.61	01/18/07	26.00	10/08/98	14.0 B	-1.7 B
Morgan Stanley	MS	65.39	110.00	09/12/00	18.25	10/08/98	68.8 B	-34.0 B
Lehman Holdings	LEH	64.78	86.18	02/07/07	5.66	10/08/98	34.3 B	-42.0 B
A.G. Edwards	AGE	82.65	90.44	05/31/07	22.62	10/08/98	6.2 B	+763.0 M

other four are creating, holding, and trading? This reminds me of the argument some were making in 2000 that Microsoft would be the first trillion-dollar company. The problem with that thesis is that there's a finite amount of money on the planet. If Microsoft could have gotten to a trillion in value in 2000, it would have represented 10% of the global stock market at that time. These big brokerage firms are going to hit that same wall. It's only a matter of time.

While this game of musical chairs (quarter after quarter of negative cash flow) can end at any time, the even bigger problem is the big brokers' business

I also looked at the industry as a whole over the last 10 years. From October 1995 through October 1998 (13 consecutive quarters), the brokerage industry generated annualized negative cash flow. When the market crashed in October 1998, the prices of each of the brokerage's shares fell by at least 50% from their 1998 highs (Goldman did not trade publicly until 1999). The date of the new lows for each of the brokers was October 8, 1998, and the 10-year lows for all of the brokers remains that day.

The second period where cash flow for the brokers was negative was January 2000 through March 2001. We all know

Here are my recommendations on riding out the storm:

- Avoid the securities of the five largest brokers.
- Eliminate any margin balances.
- Make sure that your mutual funds don't hold shares in the brokers.
- Take a serious look at TheRetirementSolution.com. It provides investors with an alternative to mutual funds. It utilizes StockDiagnostics.com's technology and it is as safe, or safer, than most mutual funds. It also excludes the securities of financial companies and has a bona-fide track record. (Disclosure: I am indirectly affiliated with TheRetirementSolution.com).

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models. I believe that the bulk of their record profits have become dependent on generating massive negative cash flows in order to create and resell investments that enable them to consistently generate record profits. This brings up several pertinent questions. What happens when the brokers can no longer play the mortgage game (owing to the inability of borrowers to get loans) that is vital for them to create high-margin financial products? How are they going to make up the shortfall that will undoubtedly hit their earnings estimates? Provide loans for private equity? Are all the brokers playing this game? No. A.G. Edwards (NYSE: AGE) has generated positive cash flow for each of its last five 12-month periods and has generated positive cash flow in 15 of its last 20 quarters.

what happened here. This period correlated with the dot-com crash. The third period of uninterrupted negative cash flow for the brokers started in August 2001 and ended in May 2002. The events of this period included 9-11 and Enron's bankruptcy. The final period of negative cash flow began in January 2004, and it has not yet ended. The current streak is 15 uninterrupted quarters of annualized negative cash flow and 10 consecutive quarters of negative cash flow.

Obviously, the other shoe (a significant price correction) has not yet dropped. It will most likely happen in the quarter ending September 30, 2007. That's the date all the brokers will report their quarterly earnings. Until then, they don't have to report their losses, and they have until that date to make profits, which would offset them.

Finally, the aggregate data suggests that annualized cash flows continue to increase for the non-financial components of the NASDAQ 100 and the S&P 500. The price multiples for both of the indices also remain close to 10-year lows. The Dow Jones Industrial (non-financial components) index has shown some softness in its cash flow growth, and its earnings growth is significantly higher. However, its price multiples remain near 10-year lows. Based on this information, I would expect the NASDAQ to outperform the S&P 500 and the Dow Jones Industrials indices over the next three to six months. I would also expect the S&P 500 to lag behind the other two indices because financial companies make up 20% of it. The recent volatility and turmoil in the stock market is not the beginning of a bear market. **E**



About the Author:

Michael Markowski has been writing for EQUITIES Magazine since 2003. He founded StockDiagnostics.com after doing an autopsy on Enron shortly after it filed for bankruptcy. After examining Enron's Financial Statements he found that it was simultaneously reporting record earnings while it generated record negative cash flow. Markowski's discovery led him to invent StockDiagnostics.com's patent pending OPS diagnostic charts, which are now used to monitor cash flow/earnings comparisons on over 8,000 public companies. Markowski predicted the bankruptcy of several high profile companies that were touted by Wall Street research analysts including the Fleming Companies, which was the USA's largest food distributor. Prior to its bankruptcy in 2003, the NYSE traded Fleming had a history of regularly paying dividends and had over 18,000 employees and over \$18 billion in annual revenue. Markowski also has a successful track record in identifying companies that increase significantly in value. Webex Communications, his prediction for Fortune Magazine in December of 2003, as the best performing stock for 2004, was acquired by Cisco Systems this year for a 200% gain. Finally, Markowski is a regular in EQUITIES "Favorites of the Famous" and Infocrossing, Inc. (NASDAQ: IFOX), his December 2005 pick for the most recently concluded 2006, appreciated by 93%.