USA TODAY
August 2, 2007

Wall of Worry Slams Investment Bank

By Greg Farrell

Concern over the fate of two tattered Bear Stearns hedge funds continued to cast a shadow over the stocks of Wall Street's biggest investment banks Wednesday.

On a day in which a late rally pushed the Dow up 150 points, the stocks of Bears Stearns and four other investment banks dropped slightly or eked out a tiny gain, leaving them well off their 52-week highs.

The problem, say experts on the financial markets, isn't limited to two highly leveraged Bear Stearns hedge funds that were invested in subprime mortgages. Rather, the collapse of the two funds, which are now in bankruptcy-court protection, has led investors to wonder how many other questionable assets are on the books of big investment banks.

"The core issue is that over the last five years, the number of debt securities has grown three times faster than the economy," says Richard Bove, analyst at Punk Ziegel & Co. "I don't think the economy can generate enough income to pay interest on all this debt."

Bove, who's currently bearish on the financial sector, says lenders made tons of bad loans in recent years to borrowers who were poor credit risks.

"What investors are now beginning to understand is that the banks have a lot of paper on their books that isn't worth what it's rated," he says. As a result, Bove says, investors could conclude that the earnings of these five banks might be inflated.

The problem isn't limited to Bear Stearns, he says. The implosion of the two funds was fueled by all the debt incurred by the funds to invest heavily in the subprime market. With the collapse of the subprime market, lenders began to squeeze the funds.

"Bear Stearns had the greatest stress," he says, "but the other guys have the same problems and better cash flows, so they don't have to show us."

"There's a fear," says Donna Hitscherich of Columbia Business School. "Investors don't know the level of transparency of these portfolios. Even if you can't see it, there's a wall of worry."

That perception problem is hurting another Bear Stearns fund, the Asset-Backed Securities Fund, less than 1% of which is invested in subprime mortgages.

Because investors started bailing out of the fund, Bear Stearns halted redemptions Tuesday. "There are no plans to shut down the fund," says spokesman Russell Sherman. "We believe the fund portfolio is well positioned to wait out the market uncertainty. We don't believe it's in the interest of our investors to sell assets in this current market environment."

Sherman says the fundamentals of the Asset-Backed fund are solid: Fund managers have cash on hand; they didn't borrow large sums of money, as was the case with the two funds that blew up; and the fund generates $13 million in monthly interest payments.

All the uncertainty in the financial sector could generate buying opportunities for investors, says Eric Veiel, analyst at T. Rowe Price.

"We're looking at selectively picking up stocks inappropriately brought down by fear," he says. The mutual fund firm has been buying MetLife stock recently because it seems poised for growth and its stock price is low, says Veiel.