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MARKET MOVERS

How Investors Might Ride Out Market Malaise

Recent Financial Crisis
Mimics Those of Past;
Three Hints Offer Tips

By **MARK GONGLOFF**
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Financial crises often have been marked by false dawns and punishing rude awakenings.

So, is the stock market now taking a turn toward recovery or is it repeating that history?

Stocks surged last week in an apparent bet that more Federal Reserve interest-rate cuts would be just the ticket to solving the credit crisis. It wasn't the first time. After credit worries hurt stocks in July and August, stocks rallied on rate-cut hopes in September, only to plunge again when the credit crunch refused to die.

That isn't the only way this financial crisis mimics those of the past. In fact, financial debacles, which are almost as old as finance itself and are magnified by the ebbs and flows of human emotion, unfold in at least partially predictable ways. Charles Kindleberger, the late Massachusetts Institute of Technology professor and author of the book, "Manias, Panics and Crashes," found common threads of euphoria, revulsion and swindles in cycles of the past.

That means investors may find some hints of what's to come:


Hint One: There Will Be More Write-Downs (Maybe a Lot)

Investors rushing into beaten-down financial stocks should be wary of being sucker-punched by fresh write-downs, says Bob Bruner, dean of the University of Virginia's Darden School of Business and co-author of a new book, "The Panic of 1907: Lessons Learned from the Market's Perfect Storm."

A financial crisis is a discovery process, he argues, in which the depth of everyone's exposure to market risk is bared. He estimates that process takes one to two years, on average -- and he figures the current unveiling began this June.

Japan's banks took the better part of the 1990s to dump all of their trash. Even relatively small financial

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pratfalls take awhile to unfold. During Sweden's financial crisis in the early 1990s -- which was triggered by a real-estate bubble and had a clean-up cost of only about \$8 billion in today's money -- it still took about two years for all the muck to be hosed away, according to Gerard Caprio, economics professor at Williams College, Williamstown, Mass., and a former World Bank official.

The technology bust played out similarly. The technology-heavy Nasdaq Composite Index peaked in March 2000 and didn't hit bottom until October 2002.

The depth of the current fiasco may take an unusually long time to plumb because it involves murky, hard-to-price debt instruments for which there is little or no demand. "There's liquidity and buyers, but the complexity of what they're buying is so massive, the derivatives so complex -- and since no regulatory intervention is telling banks to dump it and clean up their balance sheets -- that you have serious indigestion," says Thomas J. Barrack Jr., chairman and chief executive officer of Colony Capital.

Bottom line: If you think it is time to start bottom fishing, be prepared to ride it to deeper bottoms.

Hint Two: Cheap Does Not Equal Value

Financial crises inevitably claim victims, and this one has been no different: More than 150 mortgage lenders have filed for bankruptcy, closed their doors or surrendered to an acquirer. Some banking titans have purged their leaders.

Such carnage is manna from heaven for some investors. Distressed-asset investor Marty Whitman, chairman of Third Avenue Funds, has repeatedly cashed in on crises. He has recently invested more than \$1 billion in companies in financial distress -- including mortgage and bond insurers.

In the current crisis there are more available buyers than ever -- including massive sovereign-wealth funds in the Middle East, investors that specialize in betting on companies in distress and private-equity stockpiles. They are starting to jump in, but not everything these so-called vulture investors buy will pay off.

"You have to differentiate between what is a real value and what is simply a stock that's down a lot," says Solaris Group co-founder Timothy Ghriskey, who headed value investing at Dreyfus in the Asian financial crisis of the late 1990s.

Easier said than done. A financial stock with a price-to-book ratio of less than two historically has been considered a value, but even that isn't a sure thing. **Citigroup** Inc.'s ratio is a wafer-thin 1.3 -- but Mr. Whitman hasn't touched it, preferring firms that don't have question marks about their capital levels. Many value investors today are looking for financial companies built to ride out the crunch, with little or no exposure to subprime and healthy stores of operating capital.

Hint Three: Watch Lawmakers and Enforcers for Opportunities and Bottoms

The worst crises have brought about regulatory changes. The popping of the dot-com bubble and subsequent corporate scandals led to the Sarbanes-Oxley law that rewrote corporate-governance oversight.

With the latest crisis occurring in the middle of a heated presidential campaign, the urge to regulate the problem will be irresistible. Already Treasury Secretary Henry Paulson is pushing for a plan to freeze interest rates on some loans, and lawmakers have their own growing wish lists.

New regulations are often unpopular on Wall Street, but they can unwittingly create swinging investment playgrounds, and astute money managers will be looking for ways to profit from any new laws.

Mr. Barrack of Colony Capital reaped a small fortune in the S&L crisis buying low-priced debt for his then-employer, Texas tycoon Robert Bass. He couldn't have done it if Congress hadn't forced the S&L industry to mark down the value of its bad assets and hadn't created the Resolution Trust Corp. to package and sell those assets when the thrifts inevitably went under. That helped spawn the modern asset-backed securities market, which has since been a profit center for Wall Street.

"What made that crisis work out with market-clearing prices was regulatory intervention," Mr. Barrack says. But regulators often show up late in the game, making them a potential guidepost to bottoms. The Sarbanes-Oxley law, for instance, was passed just a few months before the Nasdaq's October 2002 bottom.

And prosecutors were just getting to work on the swindles Mr. Kindleberger documented. While there is no statistical basis for the view, in the past the first big indictments have meant a bottom is very near. Andrew Fastow, Enron Corp.'s former chief financial officer, was charged with fraud and conspiracy on October 2, 2002. The Nasdaq hit its bottom about a week later.

--Carolyn Cui contributed to this article.

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