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Wealth

Look beyond generalisations

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I'm always surprised by the sweeping generalisations made by financial commentators during times of market distress. To say that in the current environment shares of companies in the financial sector are "oversold" or "already discounting a recession" or "poised to fall much further" is a simplistic view that doesn't reflect the diversity of businesses, companies and risks present among financial firms.

Out-of-favour sectors, of course, are great places to prospect for investment ideas – precisely because of the market's tendency to make broad generalisations. The fact is that within any giant sector such as financial services, there will obviously be companies in better or worse competitive positions, with stronger or weaker balance sheets and more or less capable management. In times of uncertainty, the less discriminating the market is of such differences, the more opportunity for smart investors to take advantage.

This state of affairs was in clear relief last week at the Value Investing Congress, the investment conference I co-host twice each year, in New York and Los Angeles. Not surprisingly, financial firms were hot topics of discussion among speakers, although there was certainly no clear bullish or bearish general outlook. The ideas offered – both long and short – highlight the breadth of opportunities that can arise in times of turmoil in a given sector. Here is a sampling of well-thought-out, excellent ideas I suspect will work out well.

On the long side, Rich Pzena of Pzena Investment Management shared his analysis of Freddie Mac, which he prefaced with this emphatic statement: "I'd go so far as to say that Freddie Mac is the single cheapest stock I've seen in my career." (On the day before his presentation, Freddie Mac shares traded at just under $26.) Given his highly successful career, that is saying something.

Pzena's argument is twofold: first, Freddie Mac's earnings are likely to be much higher going forward. That is because the prices it is paying for mortgages that it will package into securities have improved markedly, thanks to mortgage sector distress.

Ah, but with more than $100bn of exposure to subprime loans, will the company survive to take advantage? Pzena believes that it will, arguing that Freddie Mac has already marked down its portfolio to a worst-case level that is unlikely to occur. With the stock trading at just above five times the $6.30 a share "normalised" level of earnings he expects when the storm clouds lift, he sees limited downside.

Second Curve Capital's Tom Brown also shared his favourite beaten-down financial stock, First Marblehead, which provides outsourcing services for student lenders. He said the company has competitive advantages, attractive cash flow characteristics and will probably continue its robust growth, yet the stock trades at less than seven times earnings. With 20 per cent annual growth and a return to a modest multiple of 13 times earnings, Brown expects the stock to triple in the next two years.

Two speakers shared short ideas at the congress. First, Bill Ackman of Pershing Square Capital gave a 144-slide presentation detailing the large losses he thinks bond insurers MBIA and Ambac are likely to incur, which he believes will lead to their bankruptcy (in full disclosure, funds I manage are short both stocks).

The core of his argument is that as these companies moved beyond the public-finance credits they originally were created to insure into insuring structured-finance products, they took on far greater and more uncertain risks for minimal compensation – a dynamic that will hurt them badly as many of these newfangled credits go bad. Whether one agrees or disagrees with Ackman, his presentation was the most in-depth investment analysis I have seen (there is a link to it at www.ValueInvestingCongress.com).

David Einhorn of Greenlight Capital also shared a short idea – investment bank Lehman Brothers. While the stock was trading 25 per cent below its 52-week high at the time of his speech (it had fallen another 7 per cent since then at the time of writing), he believes investors have been far too quick to believe management's assertions that the company has hedged what minimal exposure is has to the toxic financial products that have caused such distress at other firms. He shared a detailed analysis of Lehman's balance sheet that led him to believe that the company will incur losses far beyond what the market is expecting.

Lisa Rapuano, Bill Miller's former lieutenant at Legg Mason and now running Lane Five Capital, did not have a financial idea to discuss, but did have some wise words in warning the investor audience against hubris. "I'm not Warren Buffett and neither are you," she said. "You have to think for yourself, be original, use your particular talents and learn."

That's more important to remember than ever when the market offers as many challenges – and opportunities – as it does today.

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