Why you should care that Lehman went bust

Bank failures make for big headlines on Wall Street, but they matter to you

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Lehman Brothers will soon be no more. Merrill Lynch is being acquired by Bank of America. And AIG is desperately trying to shore up its capital.

These events are, without exaggeration, the biggest Wall Street headlines in a decade.

Even though Lehman Brothers was larger and older than Bear Stearns – its existence *predates the Civil War* – it was the first to get that dreaded dose of tough love. There was no Barclays or Bank of America deal, no "good bank"/"bad bank" arrangement – for the first time this year, the government allowed a large financial player to fail.

The implications of this failure are massive, and they'll be absorbed over a period measured in months, not days. For one, Lehman's 25,000 employees face an uncertain future. Its customers, many of them big financial institutions, will have to unwind what are bound to be extremely complicated transactions. And investors will have to figure out what to make of the largest U.S. investment bank failure since Drexel Burnham Lambert in 1990.

To get after that last issue, I asked a panel of Fool advisors and analysts to share their thoughts on these events. Here's what they had to say.

As of Friday's close, Lehman traded hands for $3 and change, down more than 90 percent from its 52-week high. Not many average Joe investors held this stock. So why is this failure so far-reaching?

Bill Mann, advisor: Lehman matters for its role in the financial markets far beyond its own capitalization. Lehman owned some $600 billion in assets, some more liquid than others, all of which are likely to be sold during bankruptcy. There should be no doubt, for example, that some of the extreme levels of volatility in emerging markets have come from Lehman Brothers selling heavily to raise cash in the face of this crisis.

Andy Cross, advisor: Lehman is the latest financial butterfly to flap its wings, and it'll have ripple effects throughout the entire world of finance. What's interesting in this case is that the Federal Reserve put its hand up to say "enough." After bailing out Fannie Mae and Freddie Mac, and backing the JPMorgan Chase buyout of Bear Stearns earlier this year, the Fed apparently decided that Lehman did not qualify as "too big to fail."

Tim Hanson, senior analyst: This isn't just about Lehman. The company's bankruptcy filing this morning is the latest symptom of a sick financial sector. In a way, this whole experience illustrates just how intertwined the global economy actually is. What started as the admirable goal of helping a few more people own their own home and jumpstart a slowing economy in the wake of crisis (Sept. 11, 2001) ended up inflating a massive housing bubble, encouraging financial institutions to take on unprecedented amounts of risk, taking down a number of venerable financial institutions, and decimating consumer confidence. This has essentially put us back to where we started: looking for ways to jumpstart a slowing economy in the wake of crisis. It will, however, take time. Lehman now must unwind its enormous trading positions, which will put greater downward pressure on asset values in the near-term.

Can U.S. taxpayers in any way rejoice that this marks a tide change in how the government handles large, failing financial institutions (or non-financial institutions)?

Mann: I think we can describe this past weekend's events as an accidental victory for capitalism. Several big banks and several government entities sat in a room with the express purpose of figuring out how to rescue Lehman Brothers. The government stated that it would not guarantee Lehman's liabilities, and one by one the banks dropped out of the bidding.

Now, recent activities in subprime securities notwithstanding, these big banks are run by fairly smart people, all of whom came to an obvious conclusion: If they did not step in and help rescue Lehman Brothers, their own stocks were going to be mauled. And yet they *still* decided that taking on the risk wasn't worth it.

In the end, no one stepped in, and Lehman filed bankruptcy and will be wound down. While it probably feels a lot worse today around the globe as the financial system takes a massive shock, I believe that Lehman's failure will help clean out the system faster than if billions of capital were being used to prop it up.

Of course, the cynic in me also says that Wall Street probably has learned two additional lessons. First, if you're going to fail,

be the first to do so. Bear Stearns got help. Lehman got bupkis. And second, if you're going to take on risk, don't just put your company at risk – make sure you rope in whole segments of the global economy.

Cross: The optimist in us all searches for the silver lining when we see a 158-year-old firm collapse under its own heavy leverage and poor risk management. I'm encouraged that the U.S. government apparently knows when to say "no." Too bad so many once-stout investment and traditional banks didn't have the same discipline when they were writing or selling risky loans and financial instruments.

Bill Barker, **senior analyst**: In any way? Well, rejoice is a little strong, but let me count the ways investors can be grateful:

- Less taxpayer money used to largely reward undeserving executives.
- There should be a renewed sense of urgency on the part of any financials with deeply flawed models and sketchily capitalized balance sheets to fix their problems now instead of waiting for help.
- The market is all about getting rid of uncertainty.

In its own bizarre way, the government's clear statement that it won't bail out every company like Lehman makes these resolutions a bit more certain. Either these companies succeed or they fail – completely. It's slightly easier to do the math and value companies when you get into binary outcomes, rather than having to calculate multiple scenarios and assign various probabilities to outcomes that you can't even quite define. In the long run, I think this helps valuations of these companies, though obviously none of them are going to fetch better prices today.

Hanson: I'm not sure U.S. taxpayers (i.e., us) have much at all to rejoice about right about now. Our economy is fragile, we have a tremendous and growing deficit, and our obligations continue to pile up. The fact that the government did not step in here hopefully indicates that aside from the unwinding that has to take place, the Lehman fallout won't be that bad. Going forward, the government may decide that it does not want to risk having to deal with large, failing financial institutions and decides to start breaking them up – which would be bad news for Bank of A merica and its growing collection of financial assets.

In 2008, there have been several high-profile failures or near-failures: Bear Stearns. IndyMac. Fannie Mae. Freddie Mac. Now Lehman Brothers. The FDIC increased its "problem bank" list by 30 percent last quarter; there are now 117 banks on that list, totaling $78 billion in assets. Given all of this, do you think we're closer to the beginning of this mess, or the end?

Cross: My crystal ball is fuzzy on those details. And I think anyone giving you a straight answer has a bridge to sell you in Brooklyn. From what I can tell we still have a few chapters left in this story. But investors who are well-diversified across industries and market caps should be able to weather this storm, even if a few of your stocks are taking a beating today.

Barker: We're far closer to the beginning of the *number* of companies that are ultimately going to fail. There will be far more than the handful we've seen so far. But I think that we're much closer to end of general destruction of market capitalization of these companies, and the ultimate total of write-offs that we'll see from them. We've already seen far more than $500 billion in mortgage-related write-offs, and I think that's closer to the end than the beginning.

Hanson: Given that this mess is almost seven years old now, odds are we're closer to the end. That's not to say there won't be an alarming climax, but the remaining big financial institutions (Bank of America, JPMorgan, Goldman Sachs, and Morgan Stanley) look to be in better health than the companies mentioned.

For financial-related stocks, the bad news has been relentless. What would you tell investors about fishing for bargains in financials right now?

Mann: Don't be fooled. Lots of financial companies are exhibiting enormous dividend yields and look extremely cheap on a price-to-earnings and price-to-book basis. But earnings and book value are historical measures, and many banks and financial institutions have fundamentally changed. One of the fundamental rules for dealing with a burning building is not to run into it if you're already safely outside. Let others be heroes.

That said, in every sector there are good and bad companies, and the financials are no different. There are bank companies that have little to no exposure to the worst segments of the real estate market, and they're gobbling up market share. These are among the financial companies that have dropped the *least.* Companies like PNC, Wells Fargo and BB&T are quite cheap, even though they don't look like it next to their scorched cousins.

Cross: I'm not ready to double down on financials yet, but for investors who are willing to take on a bit more risk you could look at a few banks. BB&T is one of the best out there. But again, make sure you're diversified – in this environment, these bank stocks could continue moving south even if the companies' fundamentals are relatively strong.

Barker: Don't – please don't.

All right, with more color: Invest in what you know. Invest in what you understand, or are capable of coming to understand. If you think that you can figure out the balance sheets of financials – great. But you're in a very, very, very small group if you're actually able to gauge what's going on there. You might invest in Berkshire Hathaway, because if anybody's going to make the right move scavenging from this mess, it'll be Buffett and Munger. But doing it on your own? There are better opportunities out there.

Hanson: All stocks have been punished recently, not just financials. As a fellow investor pointed out to me on Friday, it's either the end of the world or an incredible buying opportunity. Either way, as a modern day Pascal might wager, we should be buying, and the best opportunities are in the non-financial stocks that have been punished without even being tied to the current crisis. There is a caveat: It could get worse before it gets better. In other words, be absolutely certain that any money you put in the market today is not money you need to pay near-term bills. Be prepared to leave today's investments alone for the next three, five, or forever years.

EDITOR'S NOTE: *Brian Richards does not own shares of any companies mentioned. Bill Mann, Andy Cross, Bill Barker, and Tim Hanson each owns shares of Berkshire Hathaway, as does The Motley Fool. Berkshire Hathaway is a Stock Advisor and Inside Value selection. BB&T, JPMorgan, and Bank of America are Income Investor recommendations.*

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