UBS

Economic Theme

It's the end of the Street as we know it (but do I feel fine?)

Sr. Equity Strategist
Jeremy A. Zirin, CFA

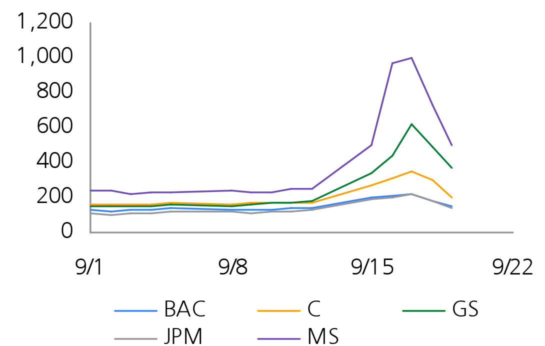
Associate Strategist
Joseph A. Sawe

At a glance

- Late Sunday night, the Federal Reserve Board approved the applications of Goldman Sachs and Morgan Stanley to become bank holding companies, pending a statutory five-day antitrust waiting period.
- There are still numerous questions that remain unanswered. The driving force behind such a move by these two venerable institutions was to rebuild investor confidence and restore financial stability through an increase in funding sources and permanent access to the Fed discount window. As a result, these firms will likely face increased regulatory oversight and reduced leverage—a positive for investors concerned about viability, but a negative for the structural profitability of the industry.
- Ultimately, independent broker/dealers need access to reasonably priced short-term funding to remain economically viable. De-risking by both diversifying into commercial banking activities and reducing leverage ratios appear to be the most logical steps needed in order to satisfy investors that downside risks are manageable.

Figure 1: Goldman Sachs and Morgan Stanley's credit default swap spreads rose well in excess of those investment banks with retail deposits

5 Year CDS spread, selected financial institutions



Source: Bloomberg, UBS WMR, as of 19 September 2008

What happened: Goldman Sachs and Morgan Stanley become bank holding companies

In response to recent market developments in which the independent broker/dealer business model has been under intense scrutiny by market participants, the two remaining US independent broker-dealers, Goldman Sachs and Morgan Stanley were both granted Federal bank holding company status by the Federal Reserve, pending a statutory five-day antitrust waiting period. Both Goldman Sachs and Morgan Stanley already have relatively small deposit-taking institutions which total approximately 2-4% of company liabilities, but this pales in comparison to 50% for many of their more diversified peers. This approval paves the way for both firms to diversify both their operations and their funding.

What it means: Three key takeaways

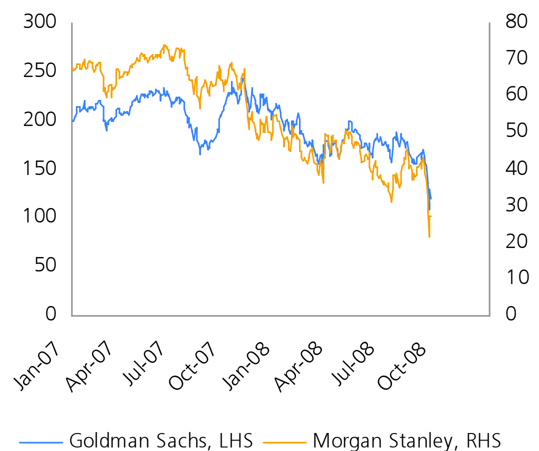
We summarize the most significant ramifications of this recent development below.

1) Business and funding diversification should help restore investor confidence

At a minimum, the announcement should remove some of the risk that stressed short-term liquidity conditions could drive yet another major Wall Street firm to the brink of existence. Both Goldman Sachs and Morgan Stanley have been able to remain profitable over the past few quarters, in sharp contrast to many peers that posted multi-billion dollar losses. But after AIG was bailed out by Treasury and Lehman Brothers filed for Chapter 11 bankruptcy, investors questioned the adequacy and viability of the business model more than the proficiency

Figure 2: Their weak and, at times, plunging stock price last week pushed Morgan Stanley and Goldman Sachs to reduce their risk profile

Closing prices, 2007 – present



Source: Bloomberg, UBS WMR, as of 19 September 2008

Past performance is no indication of future performance. The market prices provided are closing prices on the respective principle stock exchange. This applies to all performance charts and tables in this publication.

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of these firms to generate profits and manage risk. The sharp weakness in the both their credit default swap spreads and their stock prices last week sent a clear message that even the best managed investment banks are not immune to a dramatic shift in investor sentiment.

2) More secure funding—permanent access to the Fed discount window…

While investment banks did indeed have temporary access to the Federal Reserve's discount window through the creation of the Primary Dealer Credit Facility since earlier this year, becoming bank holding companies makes their access to the discount window permanent. Keep in mind that neither of these companies has needed to tap into this pool of funds, but simply its existence should further improve investor confidence and reduce the likelihood of a future shortfall in near-term funding. Additionally, a significant retail deposit base increases the likelihood that a company is deemed "too big to fail" in the eyes of the regulators.

3) …but lower structural industry profitability

But as the Nobel-prize winning economist Milton Friedman is famous for saying, "there is no such thing as a free lunch". In this case, there is a cost to both business segment diversification and to having a permanent lifeline from the Fed. Permanent access to the discount window means that the Fed will now be the primary regulatory body for these companies. As such, their ability to lever up their balance sheets will likely be constrained. Keep in mind that the more diversified universal banks typically employ far less leverage than pure-play investment banks and, subsequently, their profitability measures, such as return on equity (ROE), have averaged 500-700 basis points lower than the average ROE for Goldman Sachs and Morgan Stanley since the beginning of the decade. An additional risk is that these companies are straying from their own core competency. During the question and answer section of Goldman Sachs' quarterly earnings call seven days ago, CFO David Viniar was asked about the potential impact of becoming a bank holding company. He answered: "We never operated as a bank and it's not something we're an expert at."

Conclusion: Industry transformation begins, but still lots of uncertainties

We remain neutral on the Diversified Financial industry group in our US sector strategy. The independent investment broker/dealer model is dependent on the accessibility of short-term funding which, in turn, is dependent on investor confidence. While investment banks' balance sheets have always been opaque (often called a "black box"), the massive write-downs of mortgage-related assets combined with the continued seizing up of credit markets now appear to have permanently changed the landscape of the industry.

Appendix

Back to "At a glance"

If the date of this report is not current, the investment opinion and contents may not reflect the analyst's current thinking.

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