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Investment banking

Looking for directions

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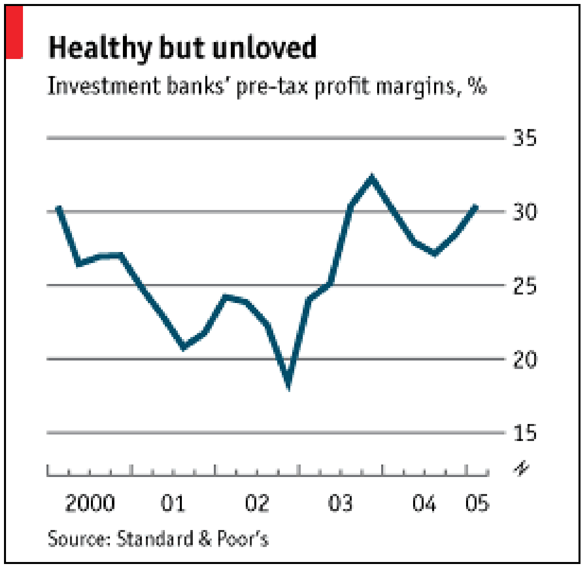
Wall Street's titans complain that the stockmarket doesn't understand their business. Given the latest results, that's no wonder

YOU might expect that the stockmarket would, if it understood no other industry, be able to fathom investment banking. Yet the heads of Wall Street's biggest firms are no different from the bosses of companies the world over, in complaining that the market consistently undervalues their shares. The Wall Streeters may have a point. Investment banks trade at below 11 times past earnings, a third less than the average listed company. And that is despite pre-tax profit margins that even in 2002, at the depth of the bear market, never dipped below 18% and have subsequently hovered around 30% (see chart). Numbers like that are the mark of a resilient and prosperous industry.



A sense of why the stockmarket views the Street so sceptically can be gleaned from the second-quarter earnings figures now coming out of investment banks. The numbers have been full of surprises, both good and bad. Overall, conditions for the industry have been decent, but not great. Markets have been a bit more volatile than they were, which can be unsettling but should still be handy for trading profits—the recent difficulties of some hedge funds notwithstanding. Short-term interest rates have continued to rise, meaning that borrowing money, an important cost, has become dearer; but long-term rates have declined, meaning better conditions for underwriting and buy-outs, both important sources of revenue.

With these conditions, it would not have been a shock if most firms had done pretty well. Instead, results have diverged widely, taking analysts by surprise on both sides. The stockmarket likes firms that earn money in predictable ways. Recently, even Wall Street seems to be at a loss to understand itself.

Prominent among the success stories was Bear Stearns. However, in areas in which it is perceived to be particularly strong, notably the trading and issuance of fixed-income securities such as bonds and mortgage-backed notes, profits dropped. It was in other areas where expectations were more modest, in particular equity trading and merger advice, that revenues were sharply up.

Lehman Brothers has been the other star, continuing a long run of good performances stretching back to the 1990s. Yet even Lehman managed a surprise, in revealing that a record 40% of its revenues came from outside America. Lehman's consistently good record has earned it, alone among the leading firms, the likelihood of an upgrade in its credit rating from Standard & Poor's, a rating agency.

In many industries, form like Lehman's would be rewarded by the stockmarket too, but not, it seems, in investment banking: Lehman's shares are priced much like its competitors'. An indicator of the market's difficulty in reading investment banks is, perhaps, that Lehman is one of the few companies whose biggest shareholders include one large mutual fund that invests only in growth stocks and another that invests only in shares that look cheap.

Oddly, the big investment bank whose price, relative to its earnings, is highest is Morgan Stanley, on the face of it the most troubled firm on the Street and arguably its most disappointing performer. On June 13th it said that its earnings would be poor. On June 22nd it reported a drop in profits of 24%, compared with the second quarter of 2004, even worse than it had led the market to expect. Revenues from trading and underwriting were down, and its retail operations are listing. Support for Morgan Stanley's shares must come from either the hope of better management or the daily rumours of a takeover.

Goldman Sachs, often thought of as the securities industry's leading light, also had a disappointing second quarter. Its earnings release raised at least as many questions as it answered. Investment-banking revenue was down a bit, although the firm said that business conditions were now improving. Worse, though, was a steep decline in revenue from trading and investment. Goldman Sachs explained the decline, a little elliptically, by saying that during the quarter it had fewer clients doing fewer things. David Hendler, a senior analyst with

CreditSights, speculates that its proprietary trading desk may have been so weighed down with various commitments that the firm could not react to improving market conditions in May, but this is just a guess. It is hard to work out where Goldman makes its money, and thus to place a value on it.

It is not just the variation and unpredictability of performance that makes investment banks hard to read. The industry is under continual legal attack. Several banks have recently shelled out billions to settle investors' suits related to the Enron affair, and more are expected to do so. The latest assault consists of class-action suits filed against Goldman and Lazard, another investment bank, concerning Lazard's initial public offering in May.

The shares were priced at $25 each, producing a total stockmarket valuation just shy of $1 billion. Investors had reason to be cautious. The financial structure of the deal was unusually complex. Pay for Lazard's bankers was significantly higher than at other investment banks. Internally, the firm was enmeshed in outright warfare between its long-time controlling shareholder, Michel David-Weill, and its current chief executive, Bruce Wasserstein. Whereas many share offerings raise money to pay for reinvestment, much of the cash from this one was needed to pay Mr David-Weill to go away. And it is a fact of equity underwriting that every dollar taken off the offering price is a dollar taken away from the seller. It is the art, and responsibility, of the underwriter to set a price that attracts buyers, yet gives the seller the fullest possible haul.

Within days of the flotation on May 5th, the price of Lazard shares had fallen to $21. Despite a bounce, it has yet to achieve the level at which the shares were sold. In response, no fewer than five law firms have filed shareholder suits against Goldman and Lazard since June 16th.

A chief contention of the plaintiffs is that both firms knew Lazard should have been valued below $22 and engaged in a complex manipulation to push it briefly upwards. Goldman unequivocally denies the charge of manipulation. Perhaps its strongest defence would be to dismiss the notion that anyone could possibly know what an investment bank was worth.