

Nontoxic Financial Stocks

The credit crisis has crimped most banks and other financial firms, but some have actually prospered. How did they survive the subprime storm?

by [Ben Steverman](#)

It has become a running theme of the credit crisis: Every week another financial firm rushes to raise capital to absorb big losses. On June 9, it was investment bank Lehman Brothers ([LEH](#)), which said it would raise \$6 billion to help deal with a \$2.8 billion second-quarter loss.

Because of the breadth and depth of damage from the subprime crisis, it can be surprising to stumble across a financial firm that has prospered in the past year. But nontoxic financial stocks—those not exposed to the ultra-risky financial instruments that have bedeviled many industry players—do indeed exist.

In even the hardest hit areas of the financial sector—like investment banks, diversified banking giants, or regional thrifts specializing in mortgages—some well-run companies have found ways to withstand the headwinds.

Toughest Environment in Memory

Take U.S. Bancorp ([USB](#)), for example. Almost all other American banking giants, starting with the largest ones, Bank of America ([BAC](#)) and Citigroup ([C](#)), have stumbled in the toughest banking environment in recent memory, but U.S. Bancorp's shares, though volatile, provided a small gain for investors since the crisis began last August.

While many hedge funds took big hits from bad subprime debt, BlackRock's ([BLK](#)) funds anticipated and profited from the mortgage and credit problems. Charles Schwab ([SCHW](#)) stayed away from the bad debt that wounded its online broker rival, E*Trade Financial ([ETFC](#)), and then benefited from its competitor's weakness by signing up new accounts.

Regional firms also impressed investors despite the crisis conditions. In Paramus, N.J., Hudson City Bancorp ([HCBK](#)) saw its shares rise almost 40% since August, while UMB Financial ([UMBF](#)) in Kansas City, Mo., is up almost 35%.

How have these firms succeeded while rivals faltered?

"It's all about capital," says Don Wordell, portfolio manager of the RidgeWorth Mid-Cap Value Equity Fund ([SMVTX](#)). Firms need enough cash to weather tough times, and those that come up short are forced to recruit new investors and issue more stock, which dilutes existing shareholders' stakes.

Debt Means a Loss of Flexibility

Successful financial firms used a variety of strategies to make sure they had enough capital.

U.S. Bancorp, for example, has garnered favorable notice by cutting costs in an already efficient organization. "If you're generating strong profit margins, you've got more room to absorb some credit issues," says Blake Howells of [Becker Capital Management](#).

Another trait of strong financial firms during the credit crisis is low levels of debt, says Terry Morris of [National Penn Investors Trust](#). "The more debt, the less flexibility you have when you have a problem," he says.

But even the most efficient and debt-free firms suffer if losses get too large. When it comes to lending and investing, many firms took risks that, in retrospect, were massive mistakes.

When Not to Follow the Herd

Successful financial firms all found ways to limit their losses from bad mortgage debt or other toxic credit instruments. Some, like BlackRock, did so by making the right bets at the right time. Most, however, avoided losses the old-fashioned way, by being careful about lending money and conservative in their investments.

"They stuck to what they did best," says Robert Ellis of financial consulting firm [Celent](#). While other banks were posting big profits from more aggressive strategies, he says, "They knew not to follow the herd. They had faith in their own business model."

Instead of making loans, packaging mortgages and selling them to investors, banks like Hudson City lent money the old-fashioned way, by holding the loans on their balance sheets. That forces a bank to be more conservative in its lending, says John Jay, senior analyst at the [Aite Group](#).

But even conservative lending practices could get you in trouble if your bank serves a niche or region hit hard by credit troubles.

For example, the housing slowdown has slammed regional banks serving Florida or California residential real estate markets.

Firmer Ground in Texas

However, Jim Bell, portfolio manager at [Liberty Ridge Capital](#), says a great place to find banks on more solid footing is Texas, where the booming energy sector has helped the economy. He owns Cullen/Frost Bankers ([CFR](#)), based in San Antonio.

Another example of a bank with a profitable niche is New York Community Bancorp ([NYB](#)). It has found little risk in its specialty of lending to landlords of New York City rent-controlled or rent-stabilized apartment buildings.

Credit quality is crucial to a bank's success in tough economic times. But firms do even better if they can make money without taking on the risk of lending in the first place.

That's why stock market favorites have been firms that earn profits from fees. "That's a much safer place to be in this market environment," says William Schultz of financial advisers McQueen, Ball & Associates.

Reliable Fee Income

T. Rowe Price ([TROW](#)), for example, earns fees by managing clients' money. Many banks that lend money also have profitable fee-generating businesses. U.S. Bancorp has both a payment-services business and a wealth management division. Firms like Knight Capital Group ([NITE](#)) and Interactive Brokers Group ([IBKR](#)) made money by handling the large amounts of trading volume on exchanges during the crisis.

Standing strong during a financial crisis has its rewards. "If you have a strong balance sheet, you're in a great position to pick up what could be cheap assets," Jay says.

Banks can lend more, on more profitable terms, while their rivals remain weak. They can "grow at the bottom of the cycle," Wordell says.

Buying Out Old Rivals

And many financial firms, especially banks, will be out hunting for competitors they can buy at cheap prices. "These guys are licking their chops," looking for buyout candidates, Jay says.

See the accompanying [slide show](#) for examples of financial stocks that have avoided the worst of the financial crisis.

If the housing, mortgage, and credit problems end soon, these stocks are likely to lose out as their less conservative rivals bounce back. But many investors are betting the damage from the past year's credit crisis will take quite a while to heal—and banks or other financial firms that "stick to the basics" will retain their appeal.

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