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THE INTELLIGENT INVESTOR
By JASON ZWEIG

Is It Time to Tiptoe Into Financial Stocks?

The Stocks May Look Cheap, But Bank On It: These Are Treacherous Waters

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Inquiring minds want to know: What would Graham do?

This column, named after Benjamin Graham's classic book on value investing, launched only two weeks ago -- and several readers have already asked whether Graham would be loading up on financial stocks now. Unfortunately, I can't ask the great investor directly[1]. Graham died in 1976. But a close look at his writings suggests that the answer is unambiguous: No.

Some value investors say today's financial stocks look like a good deal, but WSJ's personal finance columnist Jason Zweig tells Cybele Weisser they should tread carefully.

That may seem surprising. After all, by mid-July, the Dow Jones Wilshire Financials index was down 46% from one year earlier. It's such big red numbers that get value investors licking their chops.

Even after rising over 30% in the past week, the 1,001 financial stocks tracked by Dow Jones Indexes are trading at an average of just 1.1 times their book[2] value (assets minus liabilities). Before bank stocks climbed part way out of the crypt, you could buy Wachovia Corp. for 51% of reported book value. If that isn't Ben Graham territory, what is?

To see why I think Graham would sit on his hands, you need to understand his crucial distinction between investment and speculation. "An investment operation," he wrote in his first book, Security Analysis, "is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."

Trained as a mathematician and Greek and Latin scholar, Graham crafted his definition with the stark rigor of a Euclidean theorem. He wanted no weaseling about what he meant. All three, not just one or two, conditions have to be met: Your analysis must be thorough, your principal stay safe and your expectations be reasonable. "Thorough analysis" demands "the study of the facts in the light of established standards of safety and value," while "safety of principal" means "protection against loss under all normal or reasonably likely conditions or variations."

You cannot even pretend to be protected against loss while real estate prices -- the wobbly foundation for most financial stocks -- are still crumbling.

Nor can you study the facts when it's unclear what the facts are. Each quarter, the banks set money aside in reserve against losses on their loan portfolios and say they believe those reserves should be adequate. The next quarter, they find out they were wrong. Loan-loss provisions at Washington Mutual, for example, have mushroomed from $967 million to $1.5 billion to $3.5 billion to $5.9 billion over the past four quarters.

[3] **QUESTION OF THE DAY**

• **Vote**: Is it time to buy financial stocks? [4]

The banks aren't lying; they're guessing. Whenever bankers talk themselves into believing that their assets are as liquid as stocks and bonds, they end up holding some stuff so rotten that you might not be able to unload it for a nickel at closing time in a fish market. That's why Graham warned decades ago that bank stocks are "a dangerous medium for widespread public dealings," prone to "absurd overvaluation" and "violent fluctuations." That's exactly the sort of warning people forget in financial boom times, as we had until last year – and in any bounce off the bottom, as we had earlier last week.

Financial CEOs could cast a vote of confidence in the future of their companies -- and give an immediate boost to the value of each share -- by buying back stock massively at these levels. Instead, share buybacks in the financial sector have fallen by two-thirds[5] since the beginning of last year, to just $14 billion in the first quarter of 2008. Stuck in what Standard & Poor's analyst Howard Silverblatt calls "a state of shock and dismay," the heads of financial companies lack the cash or the confidence -- or both -- to buy in their own shares. If they can't or won't buy, why should you?

Don't get me wrong. I'm not saying there's no money to be made on financials in the next couple of years. But the potential for further losses is at least as great as the odds of big gains. When bankers themselves have no clue what their own assets are worth, there's no way most outsiders can determine which stocks are undervalued and which cannot be valued.

Graham warned that speculation is most dangerous when you delude yourself into thinking you are investing, take it seriously and risk more money than you can afford to lose. Many people who stampeded into financials over the past few days may end up wishing they had heeded Graham's advice. For many banks, the nightmare has only begun.

If you are still tempted to bottom-fish for financial flounder, at least diversify. Consider **Vanguard Financials** or **iShares Dow Jones U.S. Financial Sector**. Each of these exchange-traded funds holds hundreds of financial and real-estate stocks. VFH charges $2.20 in annual expenses per $1,000 invested; IYF charges $4.80. (Disclosure: Dow Jones, publisher of this newspaper, receives a portion of IYF's expenses as a licensing fee.) Whatever you do, use only the money you were salting away for that trip to Las Vegas.

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Corrections & Amplifications: Vanguard Financials' symbol is VFH. The initial version of this article incorrectly said it was VFX.

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