



TheStreet.com

September 25, 2006

Brokers May Run in Place

By Laurie Kulikowski

Brokerage stocks have had a great run since Labor Day, yet investors looking to get in on the fun could be out of luck.

Since Labor Day, the Amex Securities Broker Dealer index, which tracks the performance of brokerage stocks, is up over 5%. The S&P 500, meanwhile, is up less than 1% over that same time.

Some of the big gainers in the brokerage sector are Goldman Sachs (GS) , rising 10.6%, Lehman Brothers (LEH) , jumping 6.7%, and Morgan Stanley (MS) , climbing 5.3%.

Even the online brokers have joined in the post-Labor Day rally, although the gains have been more modest. Charles Schwab (SCHW) is up 4.4%, TD Ameritrade (AMTD) is trading 2.6% higher, while shares of E*Trade Financial (ET) are up 1.7%.

The surge in brokerage stocks comes as the big four investment firms --Goldman Sachs, Lehman, Morgan Stanley and Bear Stearns (BSC) -- all beat analyst expectations in the third quarter. Analysts and many others on Wall Street were expecting lackluster earnings as a result of the slow summer season and fear that the economy is slowing down.

But even though the brokers defied predictions of a glum third quarter and offered hope for a strong fourth quarter, now may not be the time to buy into the sector.

"It's a little bit harder to be telling people to buy the brokerage stocks too aggressively after they've had pretty meaningful price appreciation over the last couple of months," says Jeff Harte, an analyst at Sandler O'Neill & Partners. "The time to buy them was in June. There are still buys, but a lot of gains you're looking for are played out already."

He expects the fourth quarter to be another good one. But he says revenue from trading -- which has been a big driver for Wall Street all year -- may suffer a bit in the quarter as firms reduce their appetite for risk.

"There is probably an inherent decision by the trading desks to take on a little less risk in the fourth quarter, given the fact that they posted record trading levels in the first nine months of the year," Harte says.

Brad Hintz, an analyst at Sanford Bernstein, wrote in a note that he expects that next year will be challenging for the investment banks, as "a slowing U.S. economy could make the equity underwriting business softer and merchant banking gains tougher to come by."

Worse, valuations could suffer.

Hintz says he expects return on equity for investment firms to begin declining, and that will pressure price-to-book valuation, which is the main way that many analysts value the big brokers.

"We are expecting declining ROEs from the domestic investment banks through 2007, driven by headwinds from domestic fixed-income business and weakening credit quality," Hintz says.

But Giles McNamee, managing director and co-founder McNamee, Lawrence & Co., a boutique investment bank that specializes in emerging technology companies, said that it would take a major economic disaster, something comparable to the Sept. 11, 2001, terrorist attacks, to knock the brokerage firms off of their high valuations.

At 2.5 times book, investment banks are "trading at near historic highs," he says. "Brokerage firms are bellwethers. It's like a call on the economy. So if something slows down in international trade, these are the first guys that get whacked."

Others agree that the fundamental gains from the brokers are too good to pass up right now.

"A lot of them are approaching their 52-week highs," says Matthew Shields, a trader at FIG Partners, an Atlanta brokerage. "Assuming you don't see a hiccup in the market, you're going to see those broker-dealer stocks continue to rally, especially as they continue to have higher-than-expected earnings power."