

How the Crisis on Wall Street May Affect You

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What should I do if I own Lehman Brothers bonds?

Lehman Brothers had about \$150 billion in corporate bonds outstanding as of May 31. If you hold some of those bonds the first thing to do is to understand the type of bond that you hold. The price at which your bond will trade at as well as any proceeds you receive post-bankruptcy will depend on two things: first, the seniority of the bonds and second, whether your bond is secured or unsecured.

If a bond is secured that means it has the highest claim on certain company assets that back the bond. In a chapter 11 filing bondholders have a claim on those assets to help pay back the bondholders.

The seniority of a bond refers to the pecking order that determines who gets paid as company assets are unwound. One firm (CreditSights) estimated on September 14 that senior, unsecured debt of Lehman Brothers may receive 60 cents to 80 cents on the dollar in the event of a bankruptcy filing.

Once you understand where your bonds reside in the pecking order it is time to think through your situation and the future of Lehman. We now know that Lehman has filed for Chapter 11 protection. What we'll probably see is some sort of court-administered liquidation of Lehman's assets. Banks and secured creditors will come out the best under this scenario. Those who hold senior, unsecured debt will fare next best, and those who hold junior, unsecured debt will probably end up with little.

The silver lining for bondholders is that the healthier Wall Street firms are considering setting up a special fund to help finance the orderly liquidation of Lehman's assets. If this comes to pass, it should help bondholders by providing a form of price support to those assets. The more Lehman can get for those assets as it winds down its operation the bigger the pie for creditors to divide up among themselves.

If I own shares of other Wall Street firms should I sell them to avoid any fallout from the Lehman situation?

There are linkages between the various financial firms that should be taken into account when holding the stocks of Wall Street firms. Two are of particular importance.

First, many financial firms are bound by mark-to-market accounting. Loosely, this means they have to estimate the value of their assets according to what those assets would obtain if sold. Many of the assets that have bedeviled Wall Street this year are complex, thinly-traded securities whose values are often estimated. As Lehman begins to unwind its positions this provides a real (as opposed to estimated) data point that other firms must take into account when valuing their own assets. One of the reasons that other firms have no desire to see a fire sale of Lehman assets is that this might force them to write down any of their own assets that are similar in nature to Lehman's.

Second, Lehman is a counterparty to many of these firms in various sorts of trades. To the extent Lehman is unable to fulfill their obligations under these trades that creates an obligation for the firms that took the other side of the trade. While this risk is real we don't see it as a large risk at the moment. The federal government was clearly concerned about this type of domino event when Bear Stearns collapsed and was very forthcoming with federal assistance to JP Morgan to get them to take on Bear's obligations. By all accounts the feds were less forthcoming with such assistance in the Lehman situation. For example, they have expanded the types of securities that they are willing to take in collateral for loans from the Fed, but they weren't willing to go so far as to guarantee Lehman's debts. This tells us that they felt the risks to the financial system were simply not large enough to warrant that type of intervention. Their attitude was probably shaped, in part, by the fact that Lehman has been in trouble for many quarters now. As such, counterparties were well aware of their potential exposure and we believe have taken appropriate action.

This does not mean however that you shouldn't continue to expect lots of volatility from your shares in financial firms. The environment remains fluid as seemingly each day brings news that could have a large impact on any single holding. It is important that your portfolio composition match that of your risk tolerance. Financials are one of the most volatile sectors right now and whatever their investment merits, if the volatility is too much, or these stocks hold an outsized portion of your portfolio (e.g., greater than 15%) then you should consider reducing your holdings.

Financial stocks tend to pay high dividends and I've been relying on them for income. Are the dividends safe?

Many firms in the financial services industry have cut or eliminated dividends over the past year. The continuing troubles of Lehman, Fannie Mae, Freddie Mac, Washington Mutual and others point to the difficult environment in which many of these firms are operating.

One of the most important aspects to the health of these firms is to maintain their required levels of capital to support their operations. Cutting dividends to common shareholders is one of the better ways to do that.

If you rely on common dividends to generate income we suggest you review each of your holdings and ask "How stable is that dividend?" and "Is the company going to be able to pay that dividend going forward?"

Even if the answers to those questions are yes. It behooves you to not be too reliant for portfolio income on any single stock.

How does the Bank of America-Merrill Lynch deal affect me?

There are two ways of thinking about this deal and these are not mutually exclusive. On the one hand, the deal is a bright spot for Wall Street and for the economy as a whole. It says that while many financial services firms are struggling with parts of their operations and their market values have shrunk substantially over the past year, some believe there

is still value there and even (like Bank of America did in this instance) are willing to pay a hefty premium over current market prices to gain control of those assets.

On the other hand, the Lehman situation seems to have forced Merrill's hand. One reading of the situation is that Merrill saw how Lehman's position had deteriorated over time, didn't want to be in the same situation, and it decided to cut a deal now which allowed it to extract a better price that would benefit its stakeholders (e.g., stockholders and bondholders).

Ultimately the speed with which this deal unfolded is an indication that the financial crisis is far from over. As long as that is the case it has an affect on all investors in that the negative environment will be bearish factor weighing on stock prices and keep credit spreads higher than we've seen in the past. High credit spreads will tend to hurt corporate borrowers thus putting downward pressure on bond prices of all issuers except the most pristine. It will also weigh on the net asset values of bond funds that hold riskier bonds in their portfolio.

What should I be doing now with my stock portfolio right now?

The stock market is a turbulent place right now, but just because there's a lot of turbulence doesn't mean you approach the process of analyzing your portfolio any differently. Consider the following approach as a way of analyzing your portfolio from the standpoint of discipline and not emotion.

The first thing is to understand your holdings. One place to start is by considering how your equity portfolio stacks up from the standpoint of individual sectors. The present crisis has had a disproportionate impact on certain sectors of the economy like financials. What is your exposure to that area? If it is higher than 15% we consider that an outsized position and we suggest bringing it in line with market weights.

As for your other sector holdings, please consult Schwab Sector Views on schwab.com for our latest thinking on the other sectors in the economy and their outlook over the next few months.

It's also a good idea to understand your portfolio from the standpoint of its individual holdings. What are the current Schwab Equity Ratings on your individual positions? As a general rule, we don't believe there's ever a good reason to hold onto to D- and F-rated stocks. If you are currently holding them, we suggest you revisit your original rationale for holding them and consider selling.

If you have stocks rated "NR" that means something extraordinary has happened with that company—an event that renders the Schwab Equity Rating not meaningful and so we decline to rate it. If you hold NR stocks then it is a good idea to review the current news on that company and ask yourself whether those shares still fit within your investing plan.

This is also a good time to consider your overall exposure to stocks. Reacquaint yourself with the target asset allocation for your portfolio. The target asset allocation is intended to match up with your long-term needs, circumstances, and risk tolerance. If those circumstances have not changed and your portfolio has roughly the same percentage in

stocks as indicated by your asset allocation, then you're probably in good shape. Be sure, however, to assess whether your stock holdings are well-diversified and of high quality.

How is the banking system holding up?

Steering depositors away from panic and instilling public confidence in the banking system were reasons why Congress created the Federal Deposit Insurance Corporation (FDIC) in 1933 as an independent agency of the United States. The FDIC insures deposits at 8,494 banks and savings associations and is backed by the full faith and credit of the U.S. government. When a bank fails, depositors can take some comfort in knowing federal law requires the FDIC to make payments as soon as possible.

Bank failures this year (e.g., IndyMac) have placed pressure on FDIC reserves (which totaled \$45.2 billion at the end of June 2008). However, the FDIC maintains a line of credit at the U.S. Treasury and, considering the importance that policymakers place on a stable and secure banking system, we expect that the Treasury will be forthcoming with the funds necessary should the FDIC request assistance.

How can I be sure that my assets are safe at a traditional bank?

Although bank failures are relatively rare events, it's prudent to evaluate the steps you can take in order to protect the assets you have in the banking system. There are a few things to keep in mind.

First, when a bank fails (which has happened 127 times in the past 15 years), depositors can take some comfort in knowing federal law requires the FDIC to make payments as soon as possible. Based on its previous track record, the FDIC has typically made insured deposits available within a few days after a bank closing.

Second, some important advice for bank depositors is to maximize the amount of their balances that fall under the FDIC insurance safety blanket. With a little bit of planning beforehand, depositors can greatly increase their insured amounts and significantly reduce their exposure to loss should their banks fail. Consider the following:

- Make deposits at FDIC-insured banks. The FDIC logo should be plainly displayed on their Web site and in their branches.
- Make sure you understand the rules of insurance coverage. The FDIC aggregates each customer's deposits, such as checking accounts, savings accounts and CDs, into several "ownership categories" that receive separate FDIC insurance coverage. Understanding and taking advantage of these ownership categories is the primary way for depositors to maximize their FDIC-insured balances. To learn more about the ownership categories, read "Protecting Your Cash Assets" on Schwab.com/marketinsight under Market Commentary.

The simplest way to make sure you're covered is to keep no more than \$100,000 at any single FDIC insured institution.

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