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Bruised but not broken

Investors remaining vigilant after a rough-and-tumble quarter

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After being caught in a summer undertow, investors are hopeful they've paddled back to tranquil waters.

Turbulence was the norm on Wall Street in the last quarter, a rough-and-tumble period in which gains evaporated at the first mention of trouble in sub-prime lending, housing or the credit markets.

While the quarter ended on a positive note, it was a bumpy ride for many investors, as the major indices rose and fell, a ripple effect caused mainly from sub-prime loan problems. A bull market put on the brakes in July and the problem expanded in August as mutual funds and financial institutions reported losses from mortgage investments. Financial institutions started tightening lending standards and credit, in general, became less available.

"It was like being on vacation swimming and there were sharks in the water and you didn't know when they'd strike," said Gary H. Sherr, vice president of the Worcester brokerage Carl P. Sherr & Co. "There was a sense of something lurking under the water and everybody was nervous."

Stocks got off to a strong start in the third quarter and were at record highs by July 19 but there was a sudden loss of confidence and the major indices all posted negative returns for the month.

Things didn't improve much in the following weeks, and on Aug. 9 the Dow Jones industrial average fell 387.18 points, or 2.83 percent, amid deepening fears about a spreading credit crunch.

Borrowers with less-than-stellar credit defaulted on loans and bonds that backed up those mortgages dropped in value. Institutional investors and hedge funds sold stocks to raise cash to repay loans made by lenders who turned jittery over loans made to less-creditworthy borrowers.

A third quarter pullback was not a surprise to most analysts, who said the economy and Wall Street were getting a bit overheated. But the volatile swings and the breadth and depth of the mortgage problem caught many by surprise.

"The story kept on snowballing," said Gary A. Gerulskis, president of Capital Advisors LLC of Framingham. "Every time you turned around, it was affecting a different asset class."

While the Federal Reserve didn't drain the pond, it did throw out some life jackets, first injecting cash into the system and later delivering a surprising half-percentage-point cut in interest rates, the first rate reduction in four years.

The T&G/Bloomberg Central Massachusetts Index of locally based public companies was largely in line with the major stock indexes, ending the quarter with a modest return.

The price-weighted index rose 1.81 percent based on price appreciation and had a total return of 1.96 percent for the second quarter, as 14 of the 32 companies posted positive returns for the three-month period ending Sept. 28.

For the quarter, the Dow Jones industrial average ended 3.6 percent higher. The Standard and Poor's 500 index finished the quarter up 1.56 percent based on price appreciation and had a total return of 2.03 percent. The Nasdaq composite index closed the quarter with a gain of 3.77 percent based on price appreciation and posted a total return of 3.98 percent.

The T&G/Bloomberg Index held up despite negative returns from some of the region's largest public companies, including Framingham-based Staples Inc., which fell 9.4 percent for the quarter, Sepracor Inc. of Marlboro, which posted a return of -33 percent and Webster-based Commerce Group Inc., a property and casualty insurer, which declined 15 percent.

Shares of Commerce fell after an analyst downgraded the company. The outlook was revised because of expected changes in the state automobile insurance market. Commerce, the state's largest automobile insurer, is viewed as a company that might be harmed by a decision to scrap the 30-year-old system of having the state set rates for the 4 million automobile drivers in Massachusetts.

"I told people to stay calm," Mr. Sherr said of clients who own shares of Commerce. "Commerce is at the top of the hill and investors are worried that someone else will climb the hill."

While Commerce may have taken a short-term hit, it is a nimble and skilled company that knows how to sell insurance, Mr. Gerulskis said. In addition, if a large national insurer such as The Allstate Corp. wants to enter the Massachusetts market, Commerce could be viewed as an acquisition target, he said.

"Why build when you can buy?" Mr. Gerulskis said.

One local company prone to acquisitions had a robust quarter.

Shares of Hopkinton-based EMC Corp. rose 15 percent for the quarter and are up 59 percent this year.

In August, EMC spun off a 10 percent stake of its VMware Inc. software unit, a \$957 million public offering that became the biggest technology stock offering in the past three years.

Mr. Sherr, who has a "buy" recommendation on EMC, said investors are only now sorting out the data storage company's string of acquisitions.

"They're the undiscovered country," he said. "They have a pile of gold in the basement, but no one wants to go down in the basement and count it."

While EMC did fine with the VMware initial public offering, the credit crunch has taken its toll, with less cash on the street, which results in fewer stock offerings, said Thomas J. Bartholomew, president of Bartholomew and Co. Inc., a private Worcester-based investment planning company.

"What's driven a lot of this marketplace was illiquidity," he said. "The barbarians were at the gate."

Investors will remain cautious about the credit quality of mortgages and other long-term loans even as the Federal Reserve balances the merits of keeping the economy out of a recession at the expense of shielding investors from bad decisions.

Mr. Bartholomew said he expects a regular course of interest rate reductions over the next several months.

Whether the 50 basis-point rate cut is a panacea for debt problems remains to be seen, he said. The economy is slowing down, and no one can predict when the housing market will hit bottom, he said.

"The housing crisis is still going to be an issue for a long time," he said. "That's going to trickle down to the rest of the economy."

Mr. Sherr said he expects mergers and acquisitions will tighten up in the fourth quarter as those willing to buy have cherry-picked the best companies available.

"There's a sense that there's a train leaving the station," he said. "If you haven't yet done the deal, you might get left behind."

Among Central Massachusetts public companies last quarter, two deals were announced and one came to fruition.

Ailing 3Com Corp. of Marlboro, the unprofitable maker of networking equipment, closed the quarter on a high note, announcing it would be purchased for \$2.2 billion by Boston-based Bain Capital Partners LLC. The sale price will pay shareholders \$5.30 a share, a 44 percent premium over the stock's closing price the day before the deal was announced.

Applix Inc. of Westboro, which focused on software for business operations, said it would be purchased by business-management software company Cognos Inc. of Ottawa for about \$339 million.

Westboro Financial Services Inc. ceased trading in late August after the bank was purchased by Assabet Valley Bancorp, the parent company of Hudson Savings Bank. The \$20.6 million deal was slowed by court action initiated by some dissatisfied shareholders.

The third quarter was a stockpicker's market, with technology, energy and large-cap stocks performing well. In the fourth quarter, gains will likely be more broad-based, aided by an expected steady reduction in interest rates, experts said.

"That's good for supporting advances," Mr. Gerulskis said. "But what we don't know is whether investors had enough pain so that they don't go back to taking more risk than they should."