Buy Panic: Gene Marcial on How Market Meltdowns Can Be Your Ally

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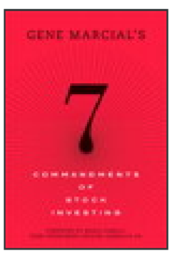
This chapter is from the book



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Buying Stocks in Trouble

Now let us look at some professional investors who are believers and practitioners of the Buy Panic maxim when it affects specific stocks or industries.

One of these investors is value investor John E. Maloney, who is chairman and chief executive officer of M&R Capital Management, Inc. Like a classic "panic player," Maloney looks for companies in trouble and whose stocks have tumbled to their lows. He jumps at opportunities to buy shares of such companies—after analyzing their balance sheets, operating margins, and cash flow, to make sure they have good chances of surviving or recovering from whatever ails them at the moment.

Maloney likes to recall what John Templeton said when he addressed a group of investment managers several years ago: "I love it when great companies get into trouble." Thus did Templeton indicate that, indeed, he was a panic buyer.

The October 1987 crash affected the entire market. Maloney hurriedly bought shares of his favorite blue-chip stocks that got swept down by the panic-sellers: Pepsi-Cola (PEP) and Dart & Kraft (DKR), which was later acquired. Those stocks rewarded him well when he sold four years later at about triple the price he had bought them.

Maloney, who cofounded M&R Capital in 1993 after more than 30 years on Wall Street as an analyst and investment banker, spends a lot of time going over about 40 stocks a week to scout for attractive stocks that panicky investors dumped. Among those he came across in 2006 were two high-profile large-cap companies that became overnight villains on Wall Street: American International Group (AIG) and Tyco International (TYC).

AIG, one of the world's giant insurance organizations, isn't a company you would expect to be a candidate for panic buyers. Its reputation worldwide as a leader in the insurance industry has made it a glamour stock for some time. Its 2006 revenues totaled $113.2 billion, with its life and general insurance business accounting for 85 percent.

Maloney bought shares of AIG on March 23, 2005, at $56.32 a share—weeks after New York State Attorney General Eliot Spitzer (now New York's Governor) and the Securities and Exchange Commission started investigations into the use of its nontraditional insurance products and certain assumed reinsurance transactions. AIG admitted to committing several accounting mistakes. Most of the problems at AIG stemmed from weak internal controls in accounting for derivatives and related assets.

"I bought shares of AIG when everybody else was panicking—the extensive probe that was being conducted didn't bother me much," says Maloney. He sensed that AIG'S earnings power was "massive" and that the problems being investigated were "manageable." Maloney figured that, in the end, the whole problem ultimately would cost AIG only $1 per share in earnings.

Trading as high as $77 in 2004, the stock fell to $49.90 at the height of the 2005 inquiry. Maloney's purchase of AIG shares at $56 a share was timely—not too far off the stock's 2005 bottom. Aware of AIG's vast assets, strong revenue growth, and solid earnings, Maloney felt confident about the company's future. By December 18, 2006, the stock had jumped to $72.81. Although Maloney had chalked up a sizable profit again, he continued to hold the stock. On December 14, 2007, at the height of the subprime debacle, the stock got caught in a web, and had plunged to $55. However, Maloney remains steadfast in his belief that AIG will climb to even greater heights—to probably around $90 a share in a year or so. Analysts figure AIG will earn $6.50 a share in 2008. On that basis, Maloney forecasts that by 2012, AIG could earn $10 to $11 a share. That will bring the stock to cloud nine, in the 90-100 zone, says Maloney.

The probe into AIG's operations culminated in a major management shakeup that resulted in the resignation of AIG's long-time CEO Maurice "Hank" Greenberg, a write-down of earnings from 2000 to 2004 totaling almost $4 billion, and a write-down of shareholders' equity of $2.26 billion. AIG also incurred after-tax charges totaling $1.15 billion to settle its numerous regulatory problems, and $1.19 billion to increase loss reserves. After all the adjustments, 2006 earnings totaled $14.1 billion, or $5.88 a share, up from $10.5 billion, or $3.77 a share, versus 2004's earnings of $9.8 billion or $3.75 a share. AIG was able to recoup much of its competitive edge even after a bumpy environment. To alleviate shareholder concerns as a result of the probe, AIG announced the repurchase of $5 billion worth of its shares in 2007 as part of a board-approved $8 billion share buyback program. It also increased dividends at a 20 percent annual rate for the foreseeable future. On October 3, 2007, AIG's stock closed at $68 a share. AIG'S former CEO Hank Greenberg is considering launching a proxy fight to regain his post, according to rumors in the industry. On November 9, 2007, *Forbes* magazine said, if successful, Greenberg would oust the board that had forced him to resign. Stay tuned on this one.

Tyco International was another stock that panicky investors dumped when everything seemed to have gone wrong in 2002 for the big conglomerate. Tyco's operations include fire-protection systems, flow control equipment, underwater communications and power cables, disposable medical supplies, and printed circuit boards. Investors bailed out because of a financial scandal surrounding its former Chairman and CEO Dennis Kozlowski.

Maloney bought shares on June 6, 2002, at $14 a share, when the company became one of the most mistrusted and spurned on Wall Street. The stock traded as high as $63 a share in 2001, but by the following year, the stock plummeted to just $10.10 a share. The investigation into the company's financial mess during Kozlowski's reign started on September 13, 2002, when the SEC filed civil fraud charges against Kozlowski, Tyco chief financial officer Mark Swartz, and chief legal officer Mark E. Belnick. The SEC accused them of failing to disclose multimillion dollar, low-interest loans they took from the company. In some instances, loans were never repaid. The men were also accused of selling Tyco shares valued at millions of dollars while their self-dealing maneuvers remained undisclosed. On June 17, 2005, Kozlowski was convicted of looting more than $600 million from Tyco, spent on lavish parties, fancy and expensive art, and an opulent $30 million Manhattan apartment that featured a $6,000 shower curtain and a $500 umbrella stand. Tyco's former chief financial officer Swartz was convicted for the same crime. Both were sentenced to 25 years in prison.

It was obvious that Kozlowski and his cohorts had committed fraud and looted the company, but Maloney figured that the company's assets, including some pieces of property appraised separately, had a total value far larger than the stock's price then. He estimated that on a sum-of-the-parts valuation, the stock was worth $40 a share. By March 5, 2007, Tyco traded at $30 a share.

It was at about that time in early March that I wrote a story in my "Inside Wall Street" column in *BusinessWeek*, suggesting that Tyco was a timely and cheap buy before the company's "three-way spin-offs." Owning 100 percent of the three companies was a big bonus for Tyco shareholders, my column said.

The new management team—led by Chairman and CEO Edward Breen—that replaced Kozlowski's gang apparently also figured the same valuation. In January

2006, the directors approved a plan to split the conglomerate into three separate publicly traded companies. Tyco split into three in June 2007.

Tyco shareholders received 100 percent of its two units: the healthcare and electronics divisions. Their allocated shares depended on how many Tyco shares they owned. The original company, Tyco International, would retain its fire and security unit, plus the engineering products and services division. By October 3, 2007, Tyco International traded at $44. Tyco Electronics, with the symbol TEL, traded at $35 that date. The healthcare unit, which renamed itself Covidien Limited (COV), traded at $41. Covidien makes plastic products for surgical use. In sum, shareholders of Tyco before the split ended up in a win-win situation: Their original Tyco had jumped from $30 to $44, and in effect their Tyco Electronics and Covidien shares were pure bonus.

Maloney figured that each of the three Tyco companies would strive to expand its respective horizons to enhance shareholder value. With the so-called "conglomerate discount" taken off their backs, each company was no longer burdened by the image of a stodgy company, and each became more flexible and ambitious to achieve its respective goals.

Maloney's buy-on-panic strategy has worked well for his company. Since 1998, Maloney's M&R Capital outperformed the S&P 500 index, except for 2006 when his gross returns of 13 percent were outscored by the S&P 500-stock index's 15.8 percent gain. Mahoney's largest gain was in 1999; his portfolio garnered a heady gain of 32.6 percent, versus the S&P 500-stock index's 21 percent gain.

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