

No Easy Fix

Wall Street's profit formula has hit a wall, and no one knows what lies on the other side.

Wall Street's money-making machine is broken, and efforts to repair it after the biggest losses in history are likely to undermine profits for years to come.

Citigroup Inc. and Merrill Lynch & Co. are among the firms that posted \$335 billion of writedowns and credit losses as the subprime debacle unfolded from the beginning of 2007 through May 13. To find out what went wrong, executives and regulators are reviewing some of the motors that powered record earnings this decade: leverage, off-balance-sheet investments, repackaging assets into bonds through securitization and credit derivative trading. Without them, firms will struggle to generate growth. "How are they going to make money going forward?" says Michael Farr, president of Washington-based Farr, Miller & Washington LLC, which manages about \$550 million. "They don't seem to know."

The collapse and emergency sale of Bear Stearns

Cos. demonstrated the perils of Wall Street practices developed after the 1999 repeal of the Glass-Steagall Act. The change allowed investment banks and depository institutions to compete with each other. "Investment banks leapt into commercial banking without the deposit base, while commercial banks went into investment banking without knowing risk management, and this is where we end up," says Brad Hintz, a New York-based analyst at Sanford C. Bernstein & Co.

UBS AG, Switzerland's largest bank, tried to bolster profits by investing in securitized assets and setting up a hedge fund. It has reported \$38.2 billion of writedowns, more than its securities unit generated in total earnings since 1998. Marcel Rohner, who took over as CEO in July 2007, told shareholders in April that the bank no longer aims to offer everything to everyone. (See "The Mess at UBS," page 32.)

With the top five U.S. securities firms losing \$110

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LEON BLACK SAID WHAT?

The Apollo Management LP founder says funding for buyouts will resume this year. **“We are well on our way. The banks will be in business again. There are already distressed opportunities.”**

billion of market value in the 12 months through April, investors are forcing changes at Lehman Brothers Holdings Inc., Morgan Stanley, Citigroup, Merrill Lynch and UBS. The banks are cutting leverage, or borrowed money they use to buy assets, by selling some stakes and raising capital. And that means eroding profitability.

Kian Abouhossein, a JPMorgan Chase & Co. analyst in London, estimates that corporate and investment banking revenue at European firms will drop 28 percent in 2008. The largest U.S. investment banks' 2008 profits will be below their levels in 2005, according to analyst estimates compiled by Bloomberg.

Securitization, used by banks and brokerage firms to repackage loans into bonds to sell to investors, is slowing dramatically. Revenue from structured debt such as mortgage-backed securities at European banks will drop 70 percent this year, Abouhossein wrote to investors. “Their profit margins won’t be as good when they curtail risk taking,” says Samuel Hayes, professor emeritus of investment banking at Harvard Business School in Boston.

Off-balance-sheet vehicles such as variable interest entities, which are used by companies to provide profits from assets they don’t own, have come under scrutiny by accounting authorities. When bonds held by VIEs are downgraded by rating firms, the assets often have to be brought onto the firm’s balance sheet. Citigroup’s maximum exposure to loss in unconsolidated VIEs was \$141 billion at the end of March, according to the bank’s annual report. Robert Litterman, an executive

at Goldman Sachs Group Inc.’s fund management unit, says that because firms are ultimately responsible for the vehicles, there’s no point in keeping them off the balance sheets.

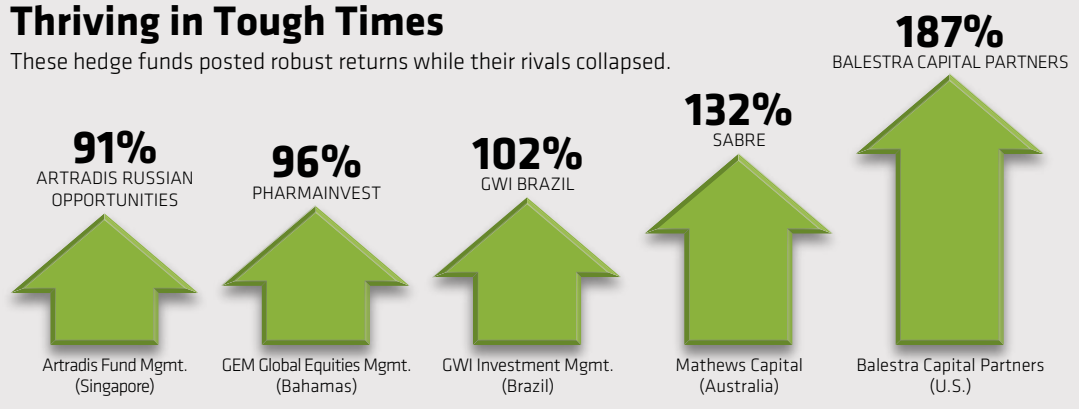
Trading in credit derivatives—financial instruments used to speculate on a company’s ability to repay debt—is also under examination amid concern that one participant’s failure to honor a contract could destabilize the entire industry. That danger, known as counterparty risk, is driving veterans of the derivatives market to call for more transparency. One proposal put forward by a group of 17 banks, brokers and industry groups is a central clearinghouse for credit derivative trades. While that might help measure and monitor the risk, it’s likely to cut into profits by limiting the flexibility to customize contracts, says David Hendler, an analyst at CreditSights Inc. in New York. (See “The Risk Nightmare,” page 50.)

The financial services sector, whose share of U.S. corporate profits almost doubled to 38 percent last year from 21 percent in 1994, may take a long time to recover, says Jeffrey Knight, deputy head of investments at Boston-based Putnam Investments, which oversees about \$190 billion of assets. “As they de-leverage their balance sheets, lending will get squeezed, hurting the economy,” says Joseph Mason, chair of the banking department at Louisiana State University’s E.J. Ourso College of Business. “A recession in turn will hurt all the businesses of these banks. Moving beyond this mess won’t be easy or fast.”

CHRISTINE HARPER and YALMAN ONARAN

Thriving in Tough Times

These hedge funds posted robust returns while their rivals collapsed.



For the 12 months ended on April 30. Includes hedge funds with at least \$100 million in assets. Source: Bloomberg

JAMIE RECTOR/BLOOMBERG NEWS

Taxing Big Oil

OIL COMPANIES WITHSTOOD pipeline bombings in Nigeria, nationalization of assets in Venezuela and Category 5 hurricanes in the Gulf of Mexico in the past year. Soon they may face a more costly foe: a Democratic U.S. president.

The election of Barack Obama or Hillary Clinton in November, coupled with a probable gain of seats in the

The most likely measure to win approval **would shift incentives to renewable energy.**

Democratically controlled Senate and House, may give the party a long-sought goal: higher taxes for Big Oil. The world's five biggest producers posted a record \$36.9 billion in profits in the first quarter, stoking the call in Washington for more levies.

Clinton is pushing for a total of \$50 billion in windfall profit and other taxes over the next decade. Obama would add a levy to each barrel of oil costing more than \$80 that, based on last year's results, could add \$15 billion a year in taxes. The most likely measure to win Democratic approval next year would shift tax breaks from oil companies to renewable energy, political analysts say. In February, such a bill lost by only one vote. "Seeing the two Democratic candidates and the closeness of that vote, I would think that would happen," says New Mexico Republican Senator Pete Domenici.



Industry lobbyists say higher taxes would mean less investment in oil production. The Energy Department forecasts prices to hover above \$3.67 per gallon through September. "Taxing profits does not produce a single of barrel of oil," says former Louisiana Democratic Senator John Breaux, an oil lobbyist.

DANIEL WHITTEN



Economic Brain Trusts

Republican presidential hopeful John McCain leans on a Washington insider for economic advice. Democrat Barack Obama listens to an academic expert on taxes. ALISON FITZGERALD

AUSTAN GOOLSBEE: 38, Obama's adviser

Preparation: Ph.D. in economics, Massachusetts Institute of Technology. The University of Chicago professor helped restructure post-communist Poland and is an expert on government finance and the Internet's economic impact. He moonlights as a *New York Times* columnist.

Influence: Washington insiders call him liberal for pushing Obama's \$1,000 tax credit to low-income families. Yet he won praise from conservative commentator George Will for blaming poor education rather than the rich for income inequality. The candidate backs a \$4,000 college tax credit.

Team: Former Federal Reserve Chairman Paul Volcker; University of California, Berkeley, economists Robert Reich and Christina and David Romer; Harvard University public policy professor Jeffrey Liebman



DOUGLAS HOLTZ-EAKIN: 50, McCain's adviser

Preparation: Ph.D. in economics, Princeton University. He served as director of the Congressional Budget Office and chairman of President George W. Bush's Council of Economic Advisers. At 31, he was on President George H.W. Bush's Council of Economic Advisers.

Influence: He's the force behind McCain's pledge to expand the president's tax cuts without blowing out the deficit by controlling spending. He sounded the alarm at the CBO about soaring Medicare and Social Security costs. McCain promises to fix Social Security's deficit and says he'll cut Medicare's drug subsidies for wealthy people.

Team: UBS Securities Vice Chairman and former Texas Senator Phil Gramm; Carly Fiorina, chairman of the Republican National Committee's Victory08 campaign and former Hewlett-Packard Co. CEO



Empty Rice Bowls

MYRNA LACDAO USED to eat two meals with rice a day. Now she eats one and gives the rest to her two grandchildren.

Lacdao, 53, shares a 70-square-foot (6.5-square-meter) shack in Manila's San Roque shantytown with her husband, two adult children and grandchildren. "I just take coffee in the morning and then have lunch at noon," says Lacdao, who makes pillowcases for sale to neighbors. "That's my first and last meal of the day."

The 8,000 families in San Roque—and the 41 percent of the nation's population living on less than \$2 a day—face more hunger as global demand for grain, speculators and biofuel production send food prices skyrocketing. Rice has jumped 172 percent in the two years ending on May 9.

The food crisis in the Philippines may also undermine President Gloria Arroyo's rule in a country where street protests toppled leaders in 1986 and 2001. Her approval rating dropped to 27 percent in March, the third straight quarterly decline, according to a survey by pollster Social Weather Stations. "This could be the tipping point," says Earl Parreño, an



analyst at Manila's Institute for Political and Electoral Reform. "Her statements must cascade into concrete steps that would put food on a poor man's table."

The administration said that it would spend 43.7 billion pesos (\$1.02 billion) through 2010 to boost rice production. "The government is sparing no effort to ensure that our supplies of rice get from the source to the tables of Filipinos throughout the nation," Arroyo said in an April speech.

San Roque sits 4 kilometers (2.5 miles) from a rice warehouse owned by the National Food Authority. Rice shortages in 1995 prompted some residents to storm the warehouse and demand that officials sell them grain. "If it reaches a point when I can't even feed my grandchildren, I wouldn't think twice about jumping that high fence and breaking into that warehouse like we did in 1995," Lacdao says.

LUZI ANN JAVIER

Filipina Myrna Lacdao can afford to eat only one meal of rice a day.

Speculating on Grain

Investors are pouring into grain futures, driving prices to all-time highs. In May, commodity index funds held 4.4 billion bushels of corn, wheat and soybeans through the Chicago Board of Trade. JEFF WILSON



Wheat
+114%



Soybeans
+125%



Rice
+172%



Corn
+175%

Two-year price increase as of May 9. Source: Bloomberg

U.K. Philanthropy Falls

THE U.K.'S LARGEST art museums and libraries, suffering from too little funding, are issuing a plea to the country's rich: Don't be so parsimonious with your charity.

In 2006, as booming U.K. financial firms stuffed a record 8.8 billion pounds (\$17.2 billion) in bonuses into bankers' pockets, philanthropy took a hit. Total donations fell 3 percent to £9.5 billion from 2005, according to the Charities Aid Foundation, which doesn't have 2007 figures yet. "We need to persuade rich people to give," says Mark Jones, director of London's Victoria and Albert Museum. "And when they give, they should be suitably celebrated."

Jones, who chairs the National Museum Directors' Conference, joined with leaders from the Museums, Libraries and Archives Council and Arts Council England at an April press conference in London to launch the Campaign for Private Giving. It's calling for government tax incentives to encourage the wealthy to make cultural donations during their lifetime and to donate artworks in addition to cash gifts.

The cultural groups say a slowing U.K. economy will likely mean less funding for the arts, making it even harder for museums and galleries to add to their collections. The Metropolitan Museum of Art in New York spent \$27.5 million on acquisitions for its 2007 fiscal year compared with £2.9 million for the British Museum in London, according to the museums' annual reports. "A very small proportion of our acquisitions in 20th-century and contemporary art come from private donors," says Jones, pointing out that major collectors in the U.S. recently gave the Seattle Art Museum almost 1,000 works of art worth \$1 billion. "There is a big contrast there."

FARAH NAYERI



The British Museum's acquisitions fall short of its New York rival's.

China's Olympic Leap

China's buildout for the 2008 games, including the National Stadium, is fueling the economy. It may top Germany this year and Japan in 2011.

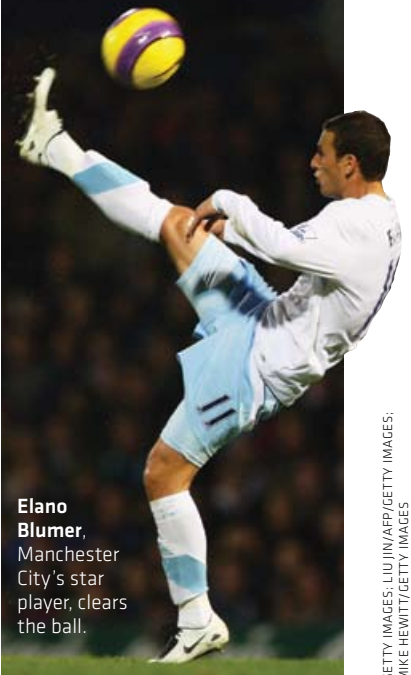


Estimates. Source: International Monetary Fund, World Economic Outlook database

Winning With Beane Counters

English Premier League clubs, inspired by Billy Beane's use of statistics to improve the Oakland Athletics baseball team, are hiring number crunchers. "It is a race," says Simon Wilson, head of performance analysis at Manchester City, which is recruiting six analysts. Clubs will scrutinize data on everything from passing speed and tackling rate to corner kicks and shooting. "Somewhere there is a key factor that can change the game," says Philip Jackson, managing director of software firm Sportstec.

ALEX DUFF



Elano Blumer, Manchester City's star player, clears the ball.

GETTY IMAGES; LIU JIN/AFP/GETTY IMAGES; MIKE HEWITT/GETTY IMAGES

Cleaning Up Siberia

YURY HOISTS A NET caked with brown sludge from Russia's Lake Baikal and curses the pulp plant he blames for killing the omul fish he relies on for income. "Two or three times a week I come home empty-handed," says Yury, 44, who asked that his full name not be used.

The Natural Resources Ministry is suing the plant, controlled by billionaire Oleg Deripaska since 2002, demanding that it be shut down and pay a 4.2 billion ruble (\$177 million) fine for polluting Baikal. The lake, the world's deepest and a United Nations World Heritage site, contains 20 percent of the world's unfrozen fresh water. The factory director says the plant pumps water from the lake, mixes it with chemicals during processing and then filters treated wastewater back into Baikal.

The lawsuit tests pledges by President Dmitry Medvedev and his predecessor, Vladimir Putin, to clean up Soviet-era industry, says Igor Chestin, director of the Russian branch of WWF, previously known as the World Wildlife Fund. "If they close the plant, it will show that environmental issues are being taken seriously at last," he says. "It is very rare that industry takes responsibility for ecological damage."



Leonid Sirotkin, head of environmental policy at Deripaska's Continental Management, which owns 51 percent of the pulp mill, says the ministry has no case and is trying to force the company to pay for damage done during the Soviet era. The federal government owns the rest of the plant. "Where is the proof that we have harmed the lake, that we have poisoned the fish?" Sirotkin says.

HENRY MEYER

Yury says pollution in Lake Baikal kills fish he depends on.

DIMITRY BELIAKOV/BLOOMBERG NEWS

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Lula's Mobile War

The president of Brazil picked a fight with Latin America's richest man.



Lula, above, pushed a Brazilian telecom merger to battle Slim.

Luiz Inácio Lula da Silva rallied a state bank and pension funds in April to help finance Telemar Participações SA's \$3.5 billion acquisition of Brasil Telecom Participações SA. The deal may help Lula fend off billionaire Carlos Slim, whose Teléfonos de Mexico SA controls 25 percent of Brazil's mobile phone market through América Móvil SAB. "Lula wants a strong Brazilian player in the telecom sector no matter what the cost is," says Cristiano Noronha, a Brasilia-based analyst at Arko Advice. The state-controlled bank and funds will hold 49.8 percent of a new company called Oi, which will own two-thirds of Brazil's land lines and 18 percent of its mobile market. Not to be outdone, América Móvil said in April that it would invest 2 billion reais (\$1.2 billion) this year in Brazil to upgrade its cell phone service, called Claro. "Oi will be able to bite some of Claro's market share by offering Internet, fixed and mobile lines in a single package," says Alex Pardelas, an analyst at Banif Investment Banking in São Paulo.

GUILLERMO PARRA-BERNAL

Kerkorian's Car Collection

After making billions from his investment in Chrysler, Kirk Kerkorian targets Ford. LAURIE MEISLER



May 1995: Banks won't finance \$20.5 billion bid to take Chrysler Corp. private; Kerkorian later boosts stake to 13.1 percent from 10 percent.



February 1996: Ends threat of proxy battle after Chrysler puts ally on board and increases share buybacks.

November 1998: Votes for merger with Daimler-Benz AG; later unsuccessfully sues DaimlerChrysler AG, saying deal was not a "merger of equals" as promised.

September 2005: Invests \$276 million and borrows about \$187 million to increase General Motors Corp. holdings to 9.5 percent.



October 2006: After GM refuses to create a joint venture with Nissan Motor Co., sells stock for small loss. Earns about \$100 million in dividends.

April 2007: Fails in \$4.5 billion bid to buy Chrysler unit. Earns a total of about \$2.7 billion on investment.

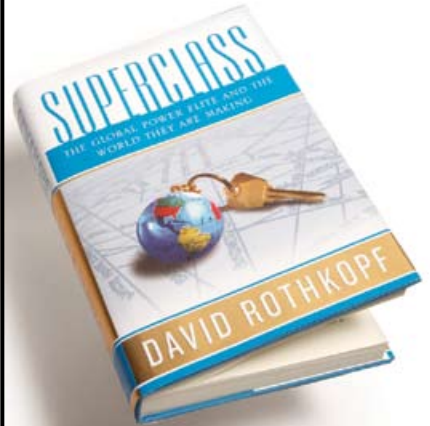
April 2008: Pays \$691 million for 4.7 percent of Ford Motor Co. Later spends \$170 million to up stake to 5.5 percent. Makes no demands—yet.



BOOKMARK

Superclass

By David Rothkopf
(Farrar, Straus and Giroux, 2008)



If you want to become as influential as Bill Gates or Stephen Schwarzman, follow these tips: Be born a male baby boomer. Attend an elite college. And don't forget to be rich and lucky. Rothkopf offers that facetious yet accurate assessment in his brainy guide to what the subtitle calls "the global power elite and the world they are making."

No stranger to the high and mighty, Rothkopf served as deputy undersecretary for international trade at the Commerce Department under U.S. President Bill Clinton and did a stint as a managing director of Kissinger Associates. He's fascinated with the people who run governments and corporations, move financial markets, shape opinion through the media and religion and deploy military forces.

Rothkopf and his researchers identified a little more than 6,000 such people worldwide. They range from the pope and Bono to steel magnate Lakshmi Mittal and Schwarzman, the billionaire head of buyout firm Blackstone Group LP. A shadow elite of criminals and terrorists making the list includes Osama bin Laden.

On a planet of 6.6 billion people, each superclass member is literally one in a million.

JAMES PRESSLEY

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