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The Case of Bear Stearns

Overview: A little more than a year ago, Bear Stearns stock hit $171 per share. On March 16, JP Morgan announced it would acquire the company for $2 per share. JP Morgan has since offered $10 per share. The following are some lessons that investors should keep in mind as Bear Stearns' situation unfolds.

JP Morgan's announcement that it would acquire Bear Stearns, the fifth largest investment bank in the United States, for $2 per share shocked the investing community, including investors who held substantial stakes in the company. The tale of Bear Stearns can serve as a reminder for investors about the importance of prudent investing. Here are some of the lessons Bear Stearns helped reinforce.

Individual Stock Speculating

British billionaire Joseph Lewis earned the nickname "The Boxer" not only because of the similarity between his name and the famous pugilist Joe Louis, but also because of his approach to his business ventures. One of his endeavors involved amassing a significant stake in Bear Stearns, giving him ownership of more than 8 percent of the company, and he was continuing to add more stock. On March 13, one of Lewis's entities purchased 569,000 Bear Stearns shares at $55.13 per share, a far cry from the $10 per share offered by JP Morgan.[1]

Billionaires were not the only individuals hurt by investments in Bear Stearns. A financial consultant purchased 4,000 shares of Bear Stearns on March 14 at $30 per share, just before JP Morgan's initial offer. The investor said the loss, which would have been a $112,000 paper loss under the original terms of the deal, would have a significant impact on his family's finances.[2]

Such tales highlight the dangers of speculating on individual stocks. Prudent investors realize that while the rewards of sinking large percentages of assets into few securities can be sizeable, it is perhaps just as likely that they will see their investments lose value.

Diversification

It is hard to top the long-term performance of Bear Stearns stock. Bear Stearns stock had an annualized return of 24.8 percent per annum from 1986 through 1999, compared with 18 percent for the S&P 500 Index. The bear market of 2000–2002 failed to deter the stock, as its total return for the three-year period was 44.2 percent, compared with –37.6 percent for the S&P 500.

As if a strong track record wasn't enough to make investors shift their holdings to dominant stakes in Bear Stearns stock, the financial media may have helped some investors decide to load up. While the market was experiencing notable volatility, a *Barron's* article from August touted investments in Bear Stearns, even though the stock was also experiencing volatility. Prior to the article's publication, the stock rose to $142 per share in mid-July, dropped to $99 per

share the Monday before the article's publication, rose to $125 per share two days later, then settled at $110 that Friday.[3]

Still, the article identified the company as an attractive takeover option for financial firms. The article's Bottom Line section summed up the article: "Bear Stearns is battered, but if it emerges intact from its latest crisis, it eventually could be sold at a price close to double its current price."[4]

A prudent strategy is to diversify assets. While investors who had concentrated positions in Bear Stearns suffered greatly, investors that owned globally diversified portfolios likely had a small percentage of their assets in Bear Stearns stock, even when it traded at its peak. This is clear demonstration of the importance of diversifying equity risks.

Confusing the Familiar With the Safe

Such a situation can be especially difficult for company employees who held large amounts of Bear Stearns stock in their retirement plans. A March 18 article in the *Wall Street Journal (WSJ)* stated that "employees at the firm are now worried not only about their jobs, but they are also helplessly watching their company-stock holdings plummet. Bear Stearns, which employs 14,000, is about one-third owned by its staff."[5]

We can only wonder exactly how much of the net worth of Bear Stearns employees was tied up in company stock because they "knew" what a great company it was. And surely they would know if there were problems. It is safe to assume those employees would not have invested in Bear Stearns stock if they were employed elsewhere. Bear Stearns was not any safer because the individuals worked there. Yet, many of those employees confused the familiar with the safe.

As the *WSJ* points out, confusing the familiar with the safe can be a problem with any firm, not just firms with records such as Bear Stearns: "One Citigroup Inc. executive who receives deferred stock as part of his bonus, said 'I've heard people saying they have nothing but Citi in their 401(k). That is the classic mistake.' And a veteran Citi broker said, 'Don't limit your investments to your company stock. That's standard advice to our clients,' and now 'the same advice we give to ourselves.'"[6]

Summary

Bear Stearns appeared to be a strong investment right up to the day JP Morgan announced it was buying the company. Instead, the company became another example of the importance of following a diversified approach to investing in equities. Prudent investors should remember the lessons reinforced by Bear Stearns.

[1] Aaron Lucchetti, **Lewis Signals Interest in Stopping Bear Deal.** *Wall Street Journal*, March 20, 2008.
[2] Paul Waldie, **JP Morgan's Bid for the Bear Leaves Investors Feeling Caged.** *The Globe and Mail*, March 20, 2008.
[3] Andrew Bary, **The Opportunity in Bear Stearns' Adversity.** *Barron's*, August 13, 2007.
[4] Ibid.
[5] Daisy Maxey, Jaime Levy Pessin and Ian Salisbury, **The Job/Stock Double Whammy.** *Wall Street Journal*, March 18, 2008.
[6] Ibid.

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