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What's Ahead For The Financial System?

By TRANG HO

Moves by Wall Street and regulators have been coming fast and furious since the U.S. government's takeover of Fannie Mae and Freddie Mac two weekends ago. IBD asked several exchange traded fund experts for their outlook on the financial industry and which ETFs they recommend now.

Paul Mazilli, director of ETF Research at Morgan Stanley:

We are neutral on the financial sector and think there is still a lot of healing to be done before long-term recovery.

While we think people are getting balance sheets under control, lower leverage and a slow economy are hurting earnings prospects. We think people need to be selective in the sector and favor ETFs with diversification and lower risk. We are still in a bear market.

We favor a number of ETFs in many markets other than the financial sector: iShares Dow Jones U.S. Telecommunications, Dow Jones U.S. Aerospace & Defense, MSCI EAFE, MSCI Hong Kong, MSCI Singapore, Taiwan; Vanguard Europe Pacific, Emerging Markets, European, Pacific; PowerShares DB Commodity, DB Agriculture, Wilderhill Clean Energy; Market Vectors Russia, SPDR Gold Trust and Claymore S&P Global Water.

Kevin Mahn, a portfolio manager at SmartGrowth Mutual Funds and chief investment officer at Hennion & Walsh; assets under management $300 million:

With the continued news and noise around AIG, Washington Mutual, Lehman Bros. and Merrill Lynch, it all seems like it's going up to a crescendo in terms of the doom and gloom and bad news. That suggests to me, looking back at history, that we're getting close to a bottom.

If you look at Bear Stearns and the short-term liquidity problems that they had, they were still bought out. The bondholders were still made whole and the stockholders got JPMorgan stock.

Something needs to turn it around but the state of financials itself isn't as dire as everyone is making it out to be. Do we really believe the mortgage market in the U. S. is dead? Do we think America, which is a society of debt, isn't going to use mortgages again and that the U.S. Treasury isn't going to issue debt again?

These are the types of businesses that built the Lehman Bros. and Merrill Lynches of the world. If they can get through this period of calamity, they're going to return to profitability in 2009.

But we're not out of the woods in any way. Commercial real estate is the next area that's going to become pressured, as we've seen on the residential side. But throw in the fact that September is usually the worst month of the year for the stock market as a whole. It won't be until November-early December that we'll have enough information about who else was impacted.

ETF picks: SPDR Financial Select Sector and Vanguard Financials.

Bill Koehler, chief investment officer, ETF Portfolio Solutions; assets under management $45 million:

These are healthy developments for the markets in general and the financials in particular. The markets are being allowed to clear and markets have to be allowed to clear. They may begin to look at what the financial landscape will be on other side of this credit crunch. Obviously somebody at Bank of America has gone through Merrill Lynch's portfolio and assigned some type of value to the distressed securities in their portfolio.

SPDR Financial Select Sector will certainly be a beneficiary.

Matthew D. McCall, president of Penn Financial Group; assets under management $20 million: I would not be surprised to see something else happening in financials.

But I think what happened here with Lehman was very important because the government did not step in as it did with Fannie, Freddie and Bear. The government let the free market take advantage of that. And we saw that with the Merrill Lynch takeover. The free market let Bank of America come in and buy it for what they thought it was worth.

SPDR S&P Biotech (and) iShares Dow Jones U.S. Medical Devices are two ETFs I do own. A medical equipment ETF, which has nothing to do with Lehman, will be down on a day like this, giving investors long-term opportunity.

Another one I own is Consumer Staples Select Sector SPDR. It gives us exposure to companies that are as far away from financials as possible. There's a good chance I'll be buying financials in the next couple of weeks or months but just not yet. As we know over history, when the mass is going one way, it's usually a buying opportunity.