Riskiest Financial Stocks Have Lowest Cost Of Capital

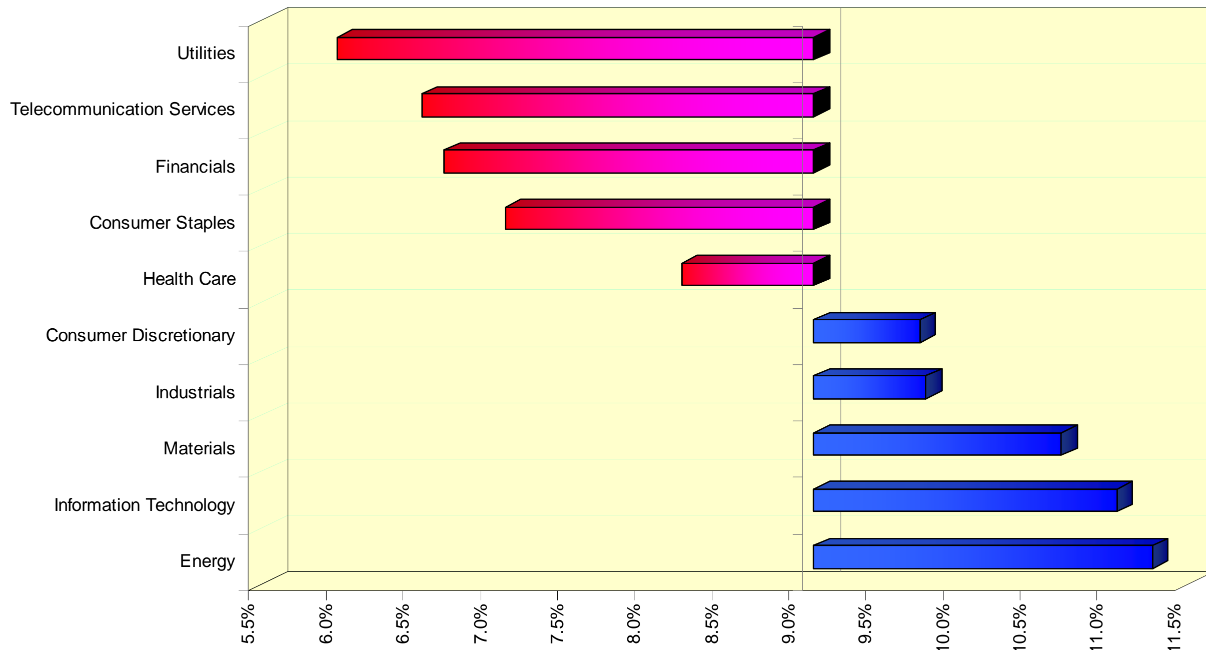
So Much For Investors Being Compensated For Risk

To turn Mark Twain on his head, which would be quite rude since the rumors of his death no longer are exaggerated, there are lies, damn lies and financial theories. Today's foray into the wormhole will cover the topic of the weighted-average cost of capital (WACC), a measure inclusive of a corporation's cost of debt, common equity and preferred stock. It is one I used to delve into with some regularity before the financial crisis of 2008; I then issued myself a cease-and-desist order as the various government bailouts and subsidies so distorted funding costs, particularly in the financial sector, that I thought the comparison would be meaningless.

Just to set the stage, the economic sector with the lowest WACC in April 2008, just after J.P. Morgan Chase (JPM) executed its shotgun wedding with Bear Stearns, was the financials. Within the financial sector itself, the lowest WACCs belonged to the group called "other diversified financial services," an interesting name for mega-banks such as Bank of America (BAC) and Citigroup (C). Other groups with low WACCs within the financial sector were investment banks and brokerages, which then still included Merrill Lynch and Lehman Brothers along with Goldman Sachs (GS) and Morgan Stanley (MS), and thrifts & mortgages, which included Fannie Mae (FNM) and Freddie Mac (FRE).

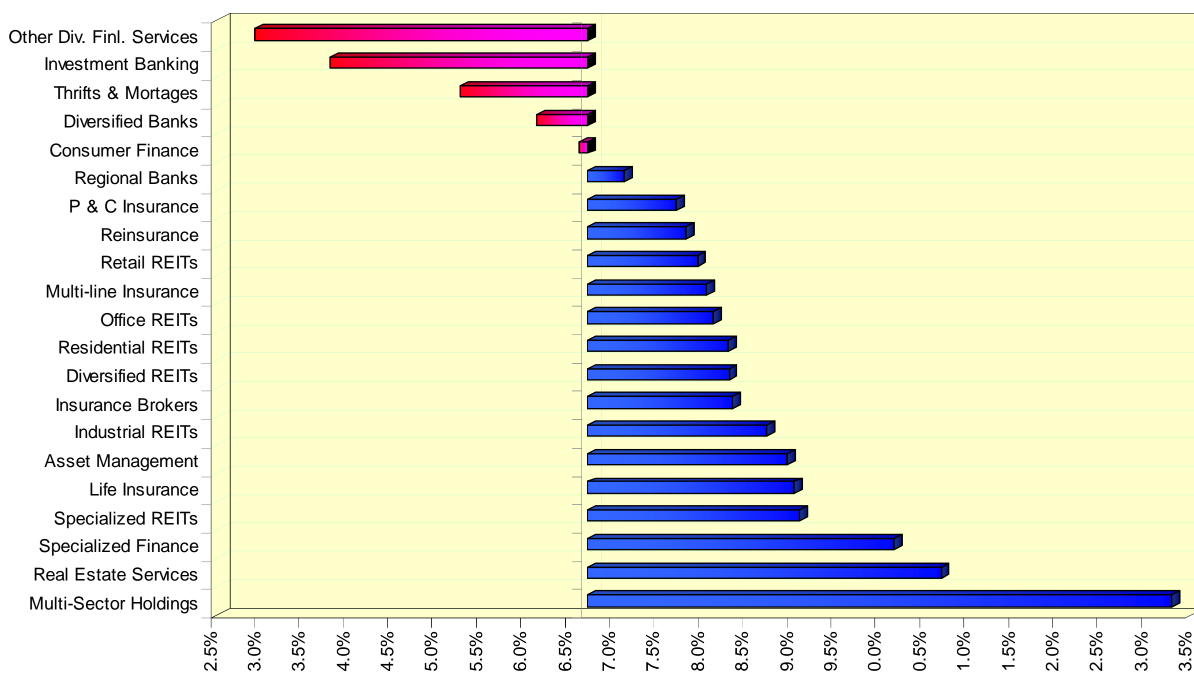
Three and one-half years later, what have we learned (Hint: Why would I be asking this question if the answer was not, "Nothing")? At present, both the utility and telecommunications sector have below-average WACCs less than the financials, but financials are still the third-lowest.

Weighted Average Cost Of Capital



Now comes the real knee-slapper: Within the financial sector, the lowest WACCs still belong to the same groups even though their herd has been culled.

Weighted Average Cost of Capital By Financial Industry Group



I can conclude one of two things here. The first is investors en masse crave financial leverage and are willing to fund it cheaply. The second is the huge presence still of government price supports, subsidies and free put options of one sort or another make these financial stocks far less risky than they might seem on the surface.

I am going to go with the former as the financial sector and these selected groups therein all had below-average WACCS prior to the financial crisis, a time when TARP simply was what the grounds crew put over the infield when it started to rain. Investors should have looked at the business models of these firms then and the fate of previous smarty-pants derivatives traders such as the late Bankers Trust, the late Enron, the late Kidder Peabody and the late Long Term Capital Management, just to name a few, and demanded some serious recompense for the use of their money. They ran funds up to the doorsteps of these banks in wheelbarrows then and continue doing so today.

Financial theory says investors should penalize riskier assets; nutrition theory says McDonalds (MCD) should make more money on spinach salads than on French fries. It will be a shame when financial textbooks go all-digital; at least now they can serve a useful purpose as landfill.