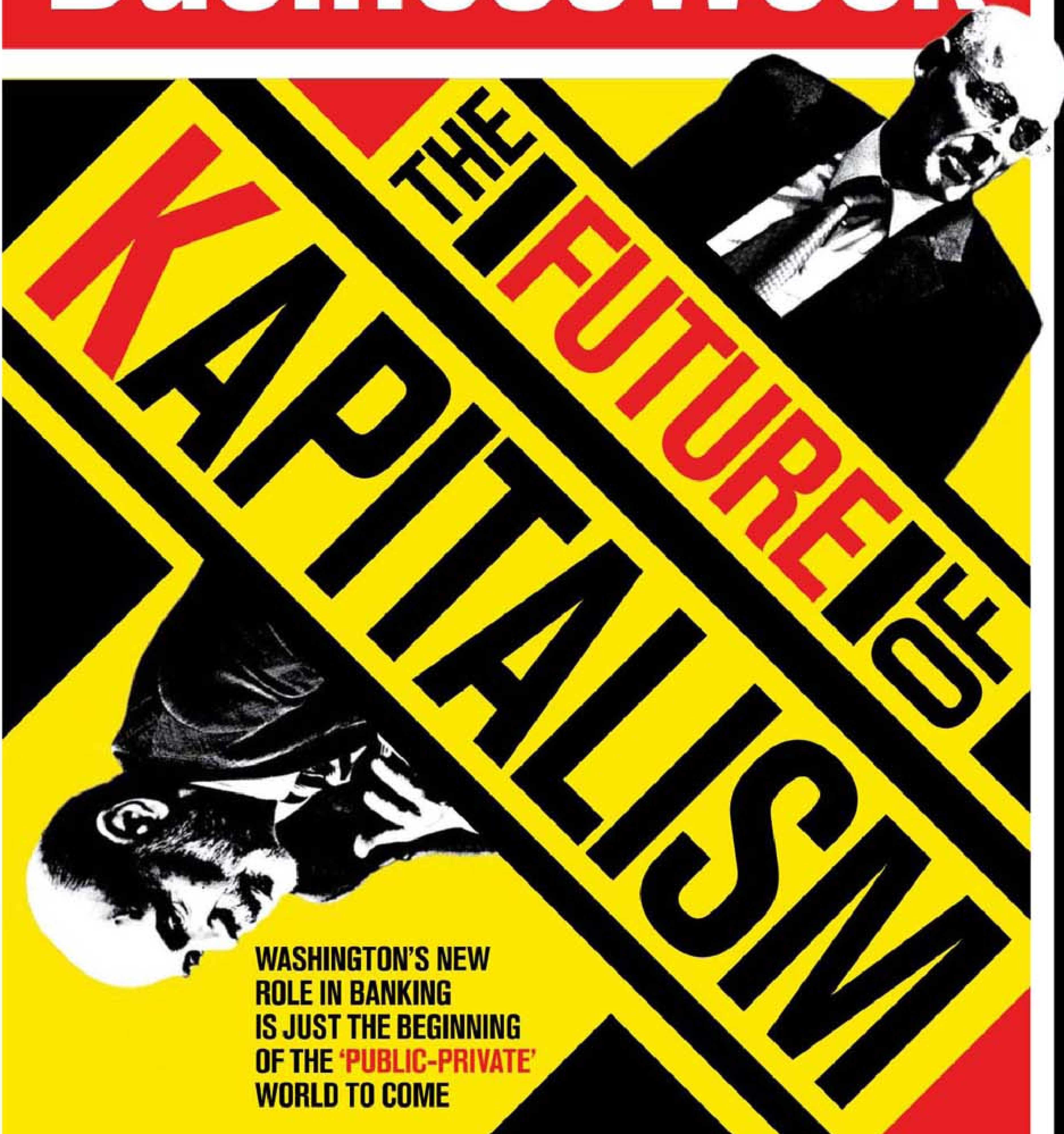
CRISIS WATCH ▸ THE GLOBAL GROWTH MIRAGE

The McGraw·Hill Companies

OCTOBER 27, 2008 | BUSINESSWEEK.COM

BusinessWeek




CAN YOU DO MORE FOR THE EARTH BY PUTTING LESS INTO IT?
WHY NOT? Of all the methods we use to reduce our environmental footprint, some of the most impactful ones are at our plants. Eight of our U.S. plants have achieved zero landfill targets – which means no waste goes into landfills. To accomplish this, we've reduced raw material usage and we're recycling virtually every material, including paper, plastics, metals, even waste water. And we're constantly looking for innovative ways to further reduce waste. Because sometimes, giving back to the earth means not giving it much at all.
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RECYCLABLE


COMPOST

HP: Innovating Towards A Low Carbon Economy

It's no secret that HP is a leader in Corporate Social Responsibility (CSR). The concept of corporate citizenship was ingrained in the DNA of the company's two founders, David Packard and William Hewlett, since the 1950s. Today, HP continues to raise the bar through a commitment to a higher standard of integrity, transparency and accountability in the 21st century.

HP recently won a Wal-Mart competition showcasing environmental innovation. The contest winner was the HP Pavilion dv6929wm Entertainment Notebook PC, an energy-efficient notebook computer with virtually no packaging, sold in a messenger bag comprised of 100 percent recycled fabrics.

Perhaps the best examples of HP's most recent work in CSR are its efforts to shrink the world's carbon footprint. "The IT sector is responsible for two percent of the world's carbon footprint, and HP is leading the effort to reduce those emissions," said John Frey, HP's senior sustainability executive. "HP provides industry leading solutions to reduce the remaining 98 percent of the global economy's carbon footprint. We see this as a huge opportunity." Frey highlighted innovative examples of ways HP limits environmental impact:

- By consolidating its 85 data centers and optimizing servers and cooling systems in the remaining six, HP expects to reduce energy consumption by up to 350 million kWh annually, saving up to $25 million each year.
- The HP Eco Highlights label helps customers identify environmental attributes of HP products and services.
- HP's Halo telepresence solution allows conferencing between participants globally, reducing necessary business air travel by 25 percent in one HP application.
- New HP Labs research initiatives aimed at developing new technologies and business models help customers reduce environmental impact.

HP's commitment to sustainability is also reflected in its supply chain.

As the world's largest IT company, HP operates the largest supply chain in the technology industry. Suppliers must comply with HP's stringent social and environmental responsibility (SER) expectations, wherever they operate.

HP has reported its own emissions since 2003 and began reporting its product transportation emissions in 2007. HP was first in the industry to announce emissions data associated with its largest suppliers and to disclose its largest suppliers, advancing supply chain transparency standards industry-wide.

Extending supply chain SER efforts, HP is addressing women's health needs at two HP supplier factories in Mexico through HERproject (Health Enables Returns project), in partnership with Business for Social Responsibility (BSR). HP hopes to expand the program to China and other companies in its supply chain.

"HP's continued leadership in supply chain SER helps achieve sustained improvement by building our suppliers' social and environmental capabilities, and also encourages others in the industry to advance supply chain responsibility," observed Tony Prophet, senior vice president, Worldwide Supply Chain Operations, Personal Systems Group, HP.

"At HP, we've fostered so much innovation within our own walls," concluded Frey. "We are now sharing our experience and solutions with customers and suppliers so they can reduce their carbon footprints and address social inequities, while boosting our collective bottom lines."

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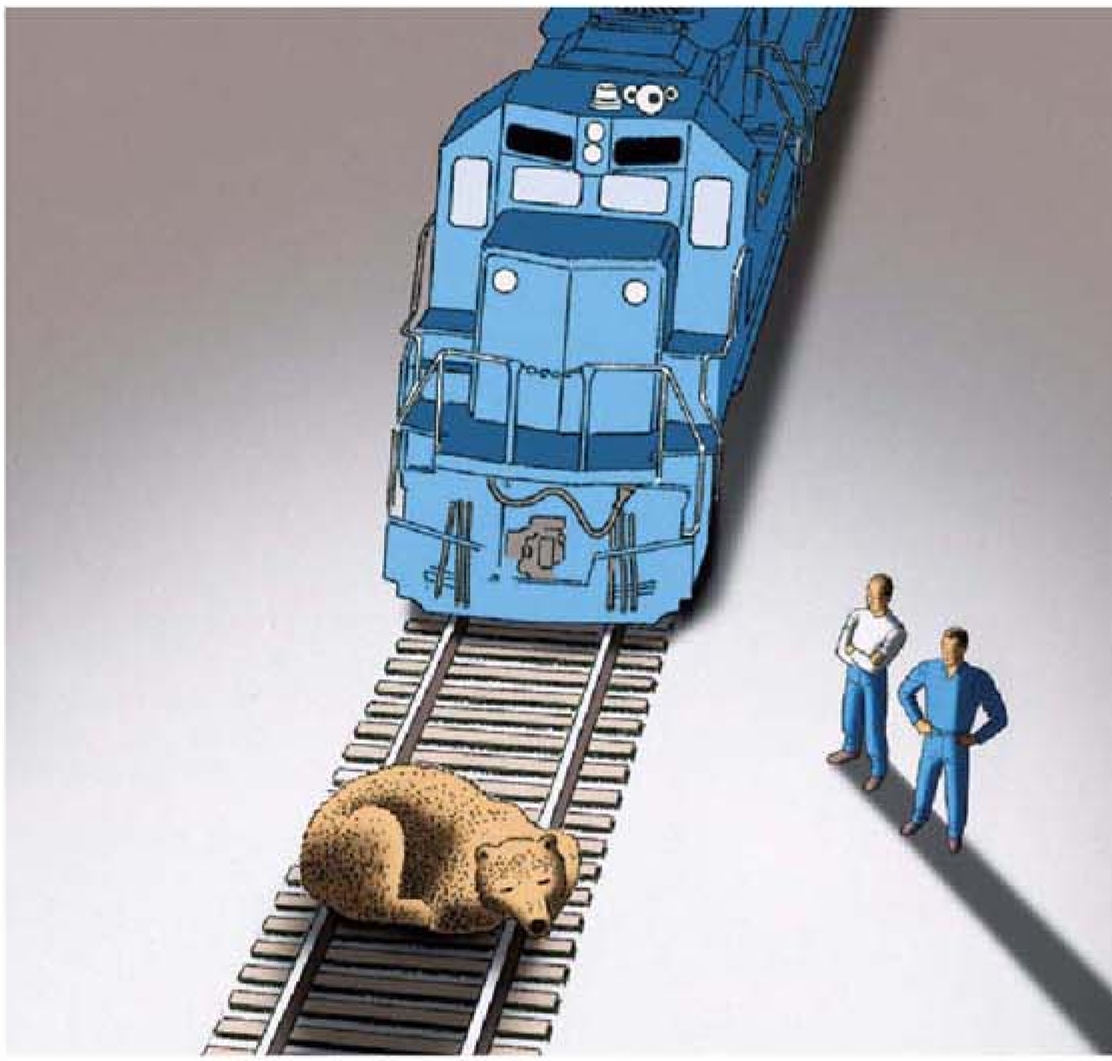


GETTING GROWTH ON TRACK

In recent years, what looked like fast growth was largely an illusion created by too much borrowing. The new formula will rely on old-fashioned essentials: productivity, innovation, and investment |BW|

PAGE 034

(COVER) BRENDAN SMIALOWSKI/THE NEW YORK TIMES/REDUX (BARNANKE); WIN McNAMEE/GETTY IMAGES (PAULSON); (ABOVE) GUY BILLOUT

EDITED BY HARRY MAURER & CRISTINA LINDBLAD

LOOKING AHEAD TO A FEARSOME RECESSION

The Big Party on Wall Street lasted exactly one day—two days, in Asia and Europe—before the euphoria wore off. On Monday, Oct. 15, the Dow rocketed up 936 points, or 11%, the biggest one-day gain since the 1930s. Other major bourses staged even headier rallies. Traders were inspired by the cascade of radical measures enacted after the weekend meeting of the **Group of Seven** nations in Washington—measures that, while not perfectly coordinated, at least were aimed in the same direction.

The key move in the U.S. was to follow Britain's lead and inject capital directly into the banks rather than using all of the $700 billion rescue fund to sop up toxic securities, as originally planned. Nine big banks are expected to share $125 billion, with another $125 billion going to smaller regional outfits. In return, Washington will get preferred shares and warrants that will allow the Treasury to recoup some money should bank stocks rise. The feds will also offer a three-year guarantee on any senior unsecured debt issued by banks through next June. That includes commercial paper in a bid to thaw that market.

European governments went even further, with Britain spending $64 billion to buy major stakes in its three biggest

At the Group of Seven meeting: U.S. Secretary of State Condoleezza Rice, President Bush, Treasury Secretary Henry Paulson, and National Security Adviser Stephen Hadley

ALEX WONG/GETTY IMAGES

banks, all of whose CEOs stepped down. France, Germany, and other EU nations also pledged to guarantee vast amounts of bank debt and to pump in capital.

Investors loved it at first but soon began to ponder the likely fallout. Despite credit starting to trickle through some sectors of the market, others remained frozen, and most experts now predict a fearsome slump that could last as long as four quarters. The **Commerce Dept.** said on Oct. 15 that retail sales in September sank by 1.2%, the third straight monthly drop and the biggest in three years. Housing prices are still on the skids, and profits are suffering. **PepsiCo,** for example, on Oct. 14 said its third-quarter net fell 9.6%; it plans to lay off 3,300 workers over three years. So with the glass looking half empty again, traders drove the Dow down 77 points on Oct. 14 and 733 more the next day.

| BW | PAGE 012 "A Direct Injection of Confidence" PAGE 022 "The New Economic Reality" PAGE 032 "A Lethal Loophole at Europe's Banks"

COMMODITIES CRASH

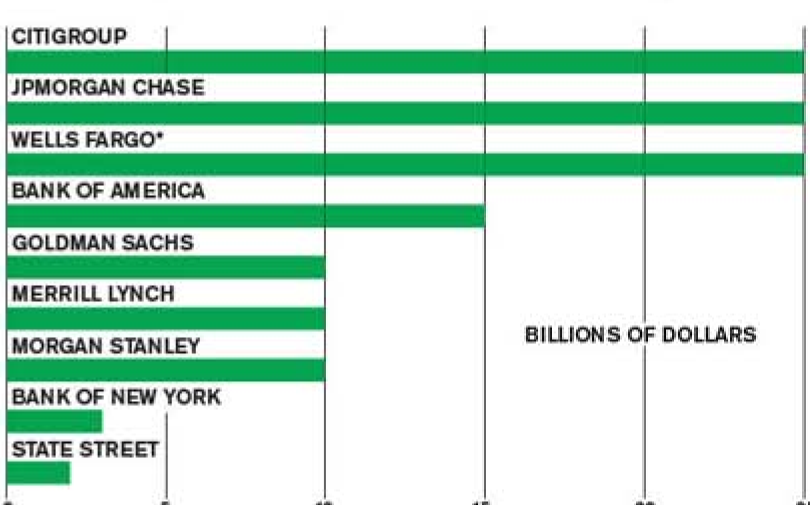
There's one big upside to the downside, of course: You'll pay a lot less for gas. By Oct. 15, with the specter of a global recession haunting the trading pits, crude oil futures had dropped to about $75 a barrel, 48% off July's high of $147. Other commodities have followed suit: Copper and iron ore prices, for example, have fallen 25% and 30%, respectively, this year, and grain prices are withering, too.

AIG'S DEEPER HOLE

One financial firm that's still scrambling: **AIG.** The insurer continues to borrow copiously from the federal government at high interest rates, pulling down $70.3 billion of its $85 billion line of credit in just three weeks. To pay that off, AIG is supposed to sell parts of itself, but so far no deals have been inked. On Oct. 13 **former CEO Maurice "Hank" Greenberg** sent a note to management appealing for a restructuring of the government's loan, arguing that its current shape "will result in the liquidation

PAULSON'S BIG BANK DEPOSIT

Amount major banks will receive under the rescue plan



Data: *BusinessWeek*

*Includes $5 billion for Wachovia

DAVID FOSTER

008 NEWS YOU NEED TO KNOW

Steve Jobs unveils the new MacBook Pro at Apple's California headquarters

of AIG, the loss of thousands of jobs, and the irretrievable loss of billions of dollars in shareholder value." But restructuring will be tough when the company keeps asking for more aid. On Oct. 8 the New York Fed agreed to bail out AIG's life insurance businesses, giving them up to $37.8 billion in cash in exchange for high-quality securities.

| BW | PAGE 033 "AIG's Rivals Smell Blood"

MORE BANK HOOKUPS

One bit of news that fed the markets' Oct. 13 glee: **Morgan Stanley** at last secured a $9 billion infusion from **Mitsubishi UFJ.** The lifeline led investors to boost Morgan shares 87% on Monday. Meanwhile, **Banco Santander** agreed to pay $1.9 billion for the 76% of **Sovereign Bancorp** it didn't already own, enlarging the Spanish bank's footprint in the U.S. The $3.81 share price is a bargain compared with the $27 Santander paid in 2005 for 90 million shares.

APPLE'S LAPTOP LINEUP

Slash prices? Fuhgeddaboutit. **Apple** took the wraps off its latest batch of notebook PCs on Oct. 14, confirming rumors that it had perfected a novel manufacturing technique that involves carving the machine's body out of a slab of aluminum. But another persistent rumor proved wrong: that entry-level prices might drop to $800. The only cut came on the low-end, white plastic **MacBook,** which now costs $999, down $100.

"Apple: New MacBooks, Same Old Prices"
businessweek.com/magazine

BETTER HEDGE THAT JOB

Everyone knows hedge funds are having a rough time, with returns down and many wealthy investors threatening to decamp at yearend. So here comes another sign of distress in the $1.9 trillion hedge universe: layoffs. On Oct. 14, **Perry Capital** axed up to 10 employees in its stock trading group. A bigger shakeout occurred at **Ramius Capital,** where 40 staffers were terminated. The downsizings were first reported on Oct. 15 by *Hedge Fund Alert*, an industry newsletter.

IT'S THE ECONOMY, FINALLY

Preparing the battlefield for their final debate clash, the Presidential candidates issued economic programs that tried to catch up with what's actually going on. On Oct. 13, **Senator Barack Obama** proposed a temporary job-creation tax credit, a waiver of early-withdrawal penalties for retirement accounts, loans to strapped states and cities, and a 90-day moratorium on foreclosures. The price tag: $60 billion over two years. **Senator John McCain** parried the next day with a $52.5 billion, two-year plan to halve capital-gains taxes, stop taxing unemployment benefits, lower taxes on up to $50,000 withdrawn from retirement accounts, and guarantee all savings accounts for six months.

ON SECOND THOUGHT...

As might be expected with the economy looking shakier by the day, two would-be buyers bailed out of unsolicited takeover bids. On Oct. 13, **Waste Management** dropped its $6.7 billion offer for **Republic Services,** the nation's No. 3 garbage hauler. And **United Technologies** gave up on its $2.6 billion bid for **Diebold,** a maker of ATMs and electronic voting machines. Except for Diebold, shares of all the companies hit yearly lows on Oct. 10.

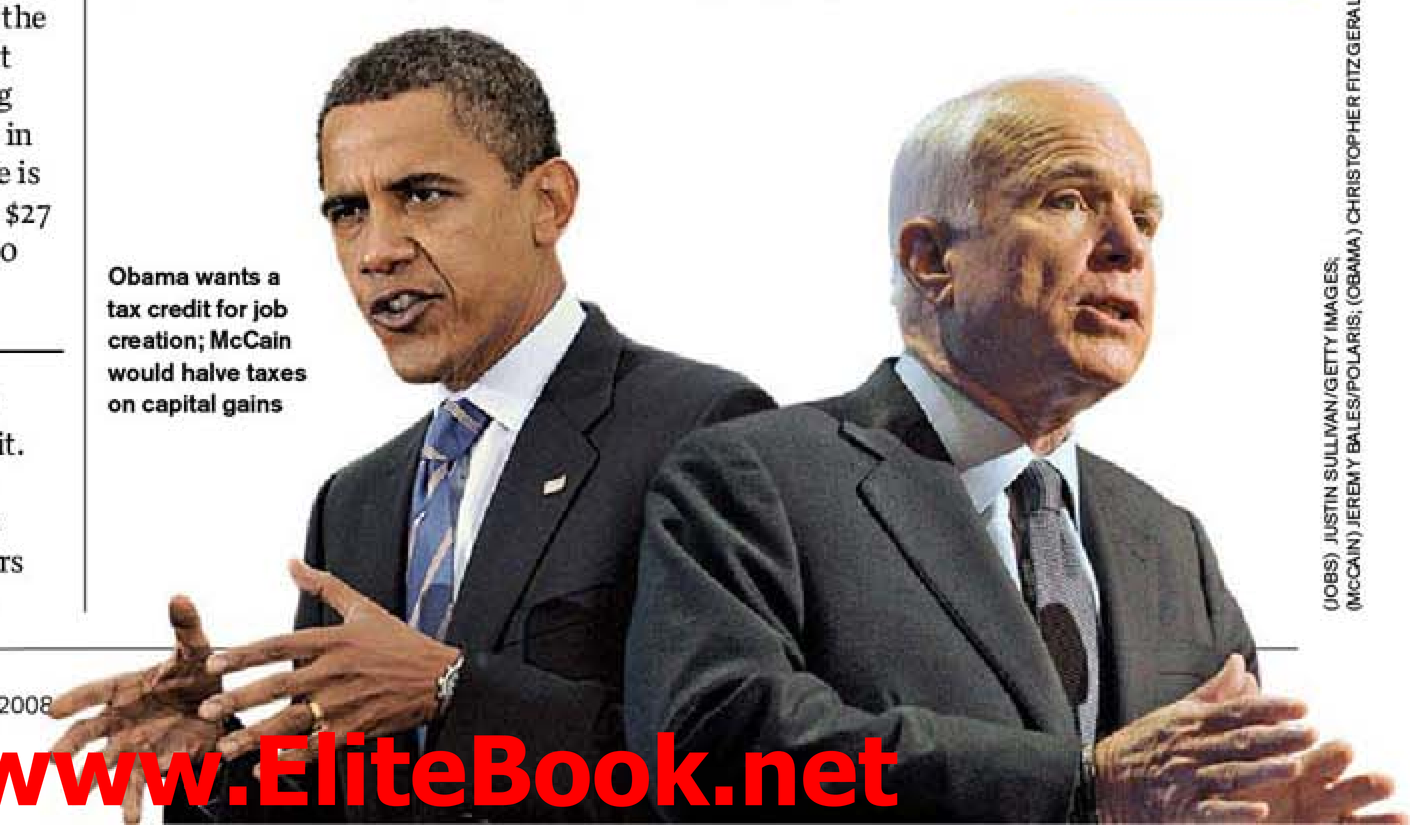
CHINA'S HOARD

While Western powers wonder how they're going to fund mas-

$75

Price of a barrel of oil on Oct. 15, a 48% drop from the peak in July.

Data: Bloomberg Financial Markets



Obama wants a tax credit for job creation; McCain would halve taxes on capital gains

(JOBS) JUSTIN SULLIVAN/GETTY IMAGES; (MCCAIN) JEREMY BALES/POLARIS; (OBAMA) CHRISTOPHER FITZGERALD/DRR.NET

A Mazda ad in Tokyo: Ford is looking to sell some of its controlling stake

sive bailouts, China's foreign currency reserves hit $1.91 trillion in September, the country's central bank reported on Oct. 14. But the rate of growth seems to be slowing: China added a piddling $21.4 billion to its reserve pile in September, about half what it had been averaging per month this year. That may mean the tide of hot money flooding into the country is receding.

China Daily

A NOBEL FOR KRUGMAN

Paul Krugman just might be the first Nobel laureate in economics who's better known for his moonlighting job. In his case, that's a twice-weekly Op-Ed column in *The New York Times*, a perch from which he often blasts the Bush Administration. But Krugman's academic work is much less political. It explains why rich countries trade with each other even though they have similar resources. Answer: It enables them to develop economies of scale in specialized products that they can sell to each other—e.g., German Mercedes for Swedish Volvos.

Krugman won for studies of trade patterns

DETROIT LOOKS TO DEAL

Could **General Motors** and **Chrysler** fix each other's drive train? GM and **Cerberus Capital Management,** Chrysler's owner, have been exploring the idea of GM acquiring Chrysler's auto business, while Cerberus would buy the 49% of GM's finance arm it doesn't already own. Executives involved unofficially confirmed the talks on Oct. 11. GM covets Chrysler's **Jeep,** minivan, and pickup truck businesses, not to mention the $10 billion-plus in cash it holds. GM executives say they would slash redundant jobs and plants. Talks have been shelved until credit markets settle down, but both companies are motivated to make it work despite hostility from the **United Auto Workers** and many analysts. **Ford,** meanwhile, is shopping a portion of its controlling stake in **Mazda** to raise $800 million to $1 billion.

"What GM Sees in Chrysler" businessweek.com/magazine

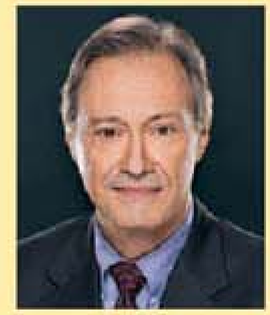
CREDIT-CARD PEACE

For settling lawsuits, there's **MasterCard.** Oh, and don't forget **Visa.** On Oct. 14 the credit-card titans settled a 2004 lawsuit filed by **Discover** alleging they had hampered its business. One practice highlighted was that the duo allegedly enforced a policy under which member banks that issued MasterCards or Visa cards couldn't offer Discover. Terms of the deal haven't been released yet, but in similar suits, **American Express** won $4 billion in settlements from the two.

CHINA'S STANDOUTS

The cover story in the October issue of *BusinessWeek China* profiles five Chinese companies that have successfully adopted Western business models while shaping them for the local market. **Red Star McCalline** has revolutionized China's furniture retailing business with its Western-style showrooms. **Haier,** the world's No. 4 manufacturer of domestic appliances, has racked up more than 7,600 patents over the last 20 years. The other standouts: **Tsingtao,** a century-old brewery; **Neusoft,** a maker of medical devices; and **99bill.com,** a fast-growing online payments platform.

(FROM TOP) KATSUMI KASAHARA/AP PHOTO; JEFF ZELEVANSKY/GETTY IMAGES



A DIRECT INJECTION OF CONFIDENCE

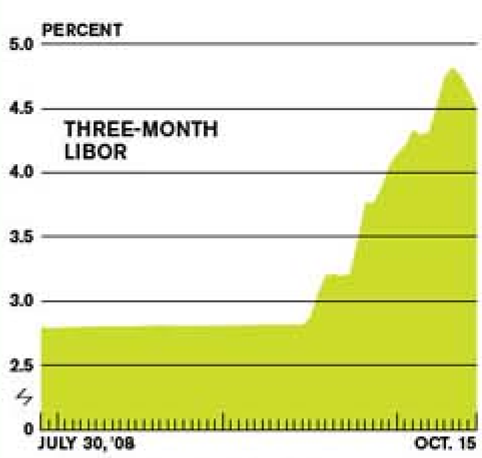
Decisions in Europe and Washington to recapitalize banks have eased worries of a global collapse, but downbeat data show they won't stave off an old-fashioned recession

It's most likely too late to save the global economy from a recession. However, judging from the sudden coordinated awakening by the Group of Seven major nations to the need for "urgent and exceptional action" on the financial crisis, the world's governments and central banks finally seem determined to limit the damage. Never mind that the G-7's bold plan of action on Oct. 10 was light on specifics. Individual governments are rapidly filling in the details as they move unilaterally to address their own needs, but with the common purpose of attacking the broader problem of eroding confidence in the financial system.

Modern finance, in which a relatively small base of capital supports a much larger volume of credit, depends on three things: sufficient capital among banks, liquidity to keep funds flowing, and trust that everyone will get paid. The problem with this financial trinity is that trust is not only dependent on the first two. It also turns on human emotion. Too much fear can bring down the house.

By virtue of its immensity, the global effort to restore trust will almost certainly succeed. Governments and central banks are offering trillions of dollars in guarantees for bank loans and deposits, purchases of impaired assets, and fresh injections of capital to a frail banking sector. The Federal Reserve is now supplying unlimited liquidity through Europe's central banks, mainly in support of dollar-denominated lending between banks.

INTERBANK LENDING RATES START TO RETREAT



Data: Tullett Prebon, Global Insight

What has become evident, however, is that measures to enhance liquidity, even this year's herculean efforts by the Federal Reserve, will not by themselves impel banks to lend when their fear of default—especially by other banks—is so high. Authorities in the U.S. and abroad are focusing on what they now believe is the core problem: the massive destruction of capital caused by markdowns of troubled assets. Restoring this financial raw material is crucial to economic growth.

To that end, the U.S. Treasury has shifted its immediate attention away from purchasing impaired mortgage-related securities and toward pumping up to $250 billion in new capital into U.S. banks in return for temporary ownership stakes. This recapitalization may well mark the beginning of the end of the crisis, although progress will come slowly. It has also become clear that the rest of the world certainly has not decoupled from the U.S. economy. The U.S. is now leading advanced economies into recession, and even outperforming developing nations are at risk of a sharp slowdown. This synchronized malaise will drag out the financial market recovery.

The lack of capital has impaired both the ability and the willingness of banks to lend. The fear driving banks' reluctance shows up in the surge in London interbank offered rates, which are set daily for interbank lending in ten different currencies. That spike hurts economic activity globally, since rates on a host of financial products are tied to LIBOR, even many mortgages. By Oct. 15, LIBOR rates had fallen for three days in a row, perhaps signaling a reversal in the climb that began on Sept. 15 (chart).

Direct capital injections not only bolster trust. They offer a bigger boost to banks' capital ratios than an equivalent purchase of illiquid mortgage-related assets. For example, U.S. banks have about $1 trillion in top-grade capital covering about $10 trillion in assets, such as direct loans and securities, for a capital ratio of 10%. Economists at Capital Economics note that if Treasury bought $250 billion of impaired assets, the ratio would rise to 10.25%, by lowering the value of the assets. But by directly adding $250 billion to capital, the ratio will jump to 12.5% for the same $10 trillion in assets.

Initially, stock markets reacted enthusiastically, but investors had been building fear of a global depression into stock prices. That worry is ebbing, but the steady stream of downbeat economic data means recent actions will not likely stave off an old-fashioned recession—nor its depressing impact on future profits and jobs. |BW|

CHART BY LAUREL DAUNIS-ALLEN/BW; PHOTO BY BRAD TRENT

"Suck in, Marge! Suck in!"

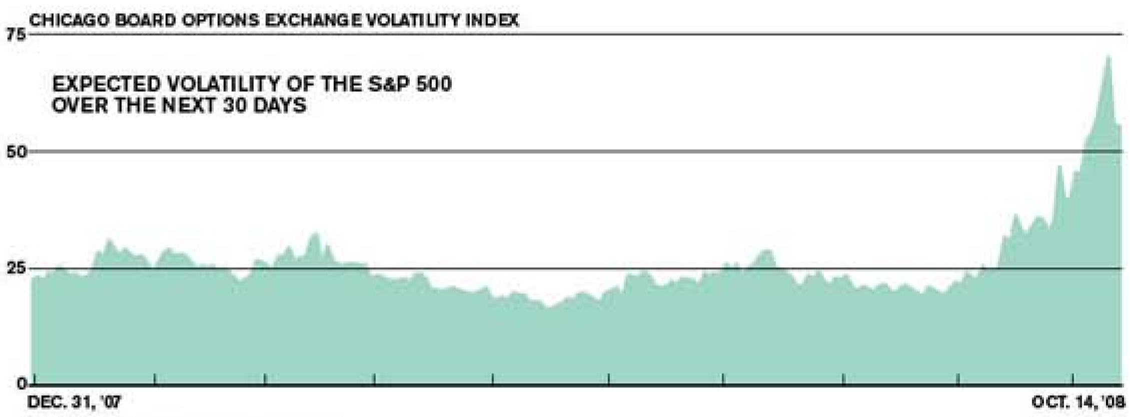
NUMBERS

THE STOCK MARKET'S STOMACH-CHURNING RIDE

By Tara Kalwarski/Charts by Ray Vella

In times of market turmoil, analysts track volatility for any indication of where the market may be headed. The VIX, which measures the expected volatility of the Standard & Poor's 500-stock index, hit an all-time high on Oct. 10—the same day the S&P hit a 5½-year low—suggesting a chaotic outlook for the next 30 days.

The VIX Index: This measure of expected S&P 500 volatility was already above its historical average before Sept. 15, when Lehman Brothers declared bankruptcy. Since then, the VIX has remained at or near record highs.



Data: Bloomberg Financial Markets

347

Number of S&P 500 stocks that experienced peak-to-trough drops of 50% or more at some point in the 10 years ending last May—before the worst of the credit crisis hit.

Data: SmartStops.net

Jumpy: Some stocks track the market more closely than others.

COMPANIES MORE VOLATILE THAN THE S&P 500	HISTORICAL BETA*
MBIA	2.56
CB Richard Ellis	2.55
Lennar	2.53
MGIC Investment	2.51
Dillard's	2.39
Pulte Homes	2.38
CIT Group	2.36

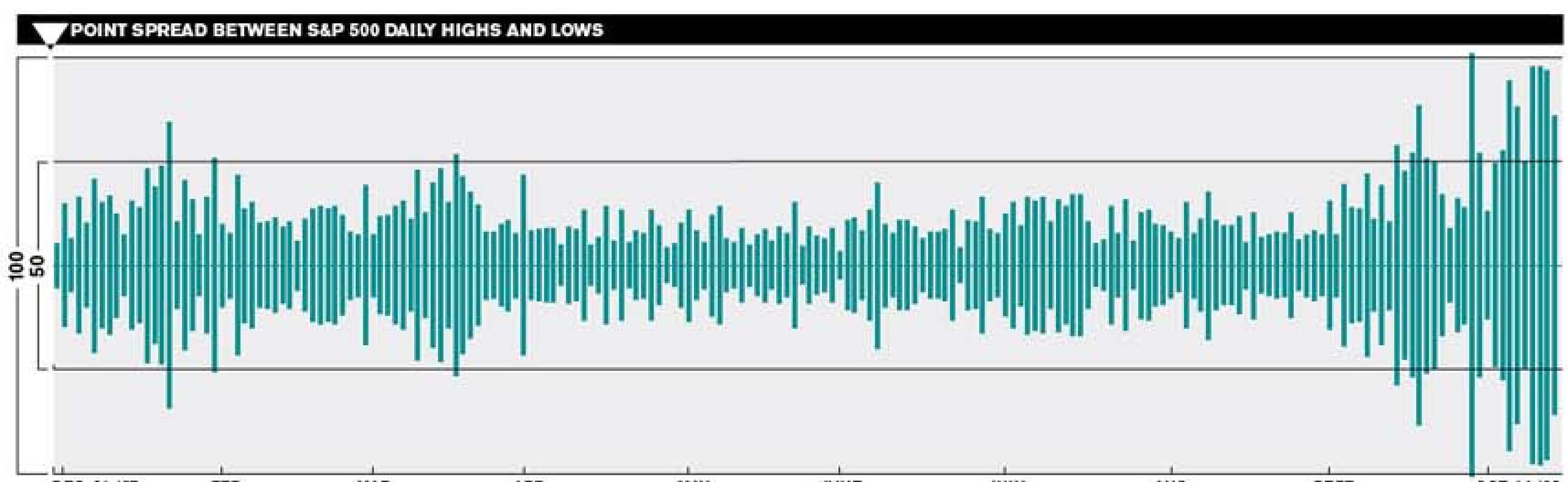
COMPANIES LESS VOLATILE THAN THE S&P 500	HISTORICAL BETA*
UST	0.09
Newmont Mining	0.30
Becton Dickinson	0.31
Amgen	0.33
Constellation Energy	0.33
Coca-Cola	0.34
Anheuser-Busch	0.35

*The beta coefficient tracks the performance of stocks vs. the overall market. Stocks with a beta greater than 1 fluctuate more than the overall market.

Data: Bloomberg Financial Markets

A DAILY ROLLER COASTER

Market volatility has heightened since Sept. 1, with the spread between daily S&P 500 highs and lows averaging 51 points, vs. 23 points in the first eight months of 2008.



Data: Bloomberg Financial Markets

EDITED BY DEBORAH STEAD

DOWNTURN CHIC

The term "recessionista" is everywhere, from *Glamour* magazine to the *Irish Times*, which recently used the word to describe a "modern sort of girl who is trying to survive the credit crunch the best she can." Despite the nod to "fashionista," the word had a different meaning when it surfaced for a while in 2001. Then, it meant someone who enjoyed predicting economic doom—"like the people who hope for a nor'easter to wash ashore, just to see what kind of havoc gets wreaked," wrote *The New York Observer* at the time. Today's recessionistas haunt thrift shops, fueling year-to-date sales growth of 6% to 15% at Salvation Army and Goodwill outlets. Goodwill's San Francisco-area outlets will launch a blog for recessionistas in November. –*Christopher Palmeri*

FRENCH REAL ESTATE LOSES ITS FIZZ

After largely escaping the woes of neighboring Spain and Britain, France's housing market has gone as flat as day-old champagne. Prices are down as much as 8% this year, according to the association of real estate agents, with a total decline of up to 15% expected by the end of 2009. And transactions in 2008's first half were down 25% from the previous year. A study by credit-insurance group Euler Hermes shows bankruptcies of real estate agencies soared 28% in the same period.

With French unemployment already at 8% and housing industry leaders warning of big job losses, President Nicolas Sarkozy announced the government will buy as many as 30,000 unfinished new homes languishing on the market.

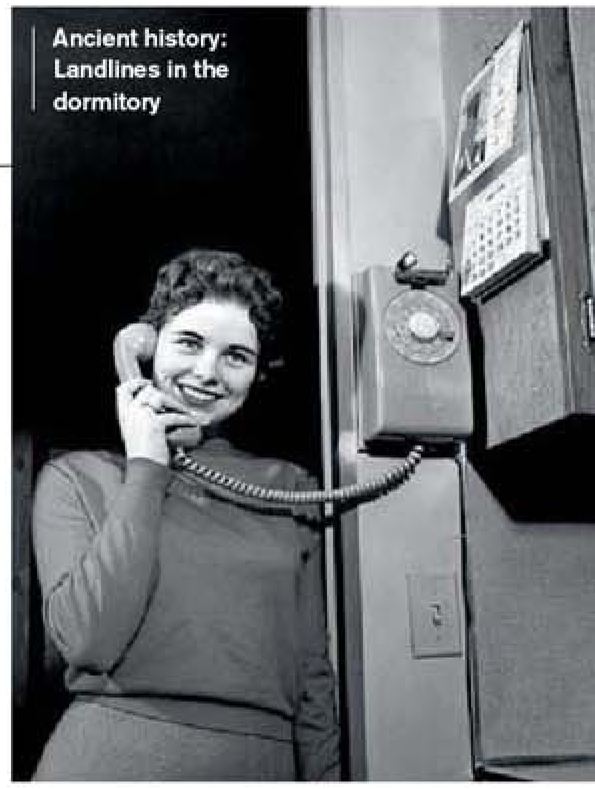
What finally caused the fizzle? Although France avoided a U.S.-style mortgage crisis, thanks to conservative lending practices, the market simply overheated. Home prices rose 210% from 1995 to 2008, even more than the 190% rise in the U.S. One factor: droves of British and American buyers, who snapped up everything from Provençal farmhouses to Paris pieds-à-terre. –*Carol Matlack in Paris*

TAX REVENUES UP IN SMOKE

Their coffers already diminished by the financial crisis, some cities are focusing on another source of leaked tax revenues: the trade in bootleg cigarettes. Last month a smuggler was sentenced to 30 months in prison and ordered to pay taxes owed on millions of cigarettes he hauled from low-tax Kentucky to resell in Chicago, bypassing the city's $3.66-a-pack tax. On Sept. 29, New York City sued retailers on a Long Island Indian reservation to stop them from allegedly selling millions of untaxed cigarettes that wind up on store shelves and street corners in the city. The per-pack tax in New York City rose to $4.25 in June, bringing the total price to $9. (Reservation residents can buy tobacco tax-free.) Statewide, some $1 billion in taxes is lost yearly because of such sales by reservation retailers, the city says. Nationwide, the bootleg trade is "thriving," says Patrick Fleenor, chief economist for the Tax Foundation. And recent tax increases like New York's will "exacerbate the problem." —*Lawrence Delevingne*

(CLOCKWISE FROM TOP LEFT) ILLUSTRATION BY RICHARD BORGE; PHOTOGRAPHS BY ERIC GAILLARD/REUTERS; NICHOLAS EVELEIGH/ALAMY

CAMPUS ELECTRONICUS



Ancient history: Landlines in the dormitory

It's a given that young people live in a high-tech world. For details, take a gander at some of the data compiled by Peter Schilling, who heads the IT department at Amherst College in Massachusetts. His IT Index, as he dubs it, shows, for example, that just 5 of 1,680 students—0.3% of the school's enrollment—have landline phones, compared with 82% of Americans. The data also capture emerging tech preferences. Freshmen (average family income: $76,183) make up half of those on campus who own an Apple iPhone or iPod Touch. In contrast to upperclassmen, first- and second-year students are also more likely to own Macs than PCs, for instance. And 89% of the incoming class applied online, vs. 33% in 2003. As for the total e-mail received on campus, 94% is spam, Schilling found. Finally, a note to orientation planners: When 99% of freshmen join Facebook groups before hitting campus, does it make sense to assume these kids haven't met? *–Heather Green*

MAKING MARKETING A PIECE OF CAKE

People differ radically on what makes things similar, concludes a new study in *Cognition*. That's a finding marketers, especially those buying search-engine ads, should heed, says its author, psychologist Zachary Estes of Britain's University of Warwick. Estes found about 50% of roughly 200 subjects defined similarity in a "categorical way," lumping dogs with cats, say, because both are animals. The other half were "thematic thinkers," who paired dogs with bones instead. Lessons: If you sell cake online, include "milk" in the search terms you buy. "Or at the grocery, put your potato chips with the beer, not just with the snacks," Estes says. *–Kerry Capell in London*

(FROM TOP) PHOTOGRAPHS BY SUPERSTOCK INC./SUPERSTOCK; (CAKE) RISER/GETTY IMAGES; (MILK) STONE/GETTY IMAGES; (OJ) STOCKFOOD CREATIVE/GETTY IMAGES; (COFFEE) IMAGE SOURCE/GETTY IMAGES; ILLUSTRATION BY RICHARD BORGE

STEERING WORKERS INTO THE GREEN LANE

Employers are getting more eco-car conscious. And not just new-guard and crunchy-granola companies like Google, Ben & Jerry's, and Timberland. Health-care company Abbott Laboratories, which provides its sales staff with some 6,000 vehicles, is revamping its mileage-reimbursement rules as part of a bid to make its fleet more carbon neutral. Now, all sales reps reimburse Abbott for personal use of company cars at 17.3¢ a mile. But starting in January 2009, those choosing SUVs instead of sedans will pay 72.3¢. The new "tax" appears to be working. With 75% of orders in for about 2,000 new vehicles, 48% of reps are requesting sedans, vs. 25% for 2008. SUV orders are at 29%, down from 44%. Hybrids? At 18%, up from 6%. *–David Kiley*

FACETIME | MARIA BARTIROMO

(TOP) BRAD TRENT; (BOTTOM) JENNIFER S. ALTMAN

ON THE GROUND WITH REAL ESTATE MOGUL BILL RUDIN

As the marathon race for the American Presidency entered its final weeks, candidates Barack Obama and John McCain got serious about rescuing homeowners trapped in bad mortgages and delivering relief to consumers being washed over by the tide of recession. Among other things, Obama called for a 90-day moratorium on foreclosures, and McCain put forth a plan that would replace some mortgages with government-guaranteed loans. To get a fix on the current state of the real estate market, I talked with Bill Rudin, president of Rudin Management, the privately held empire that has extensive commercial and residential holdings in New York City. The perilous economic times also led us to discuss the campaign by New York Mayor Michael Bloomberg to amend city rules and run for a third term. Bloomberg's pitch: Now is no time to change horses.

MARIA BARTIROMO

Both Senators McCain and Obama are proposing more direct relief for strapped homeowners. For example, McCain says he wants to replace mortgages headed for foreclosure with more manageable ones. Obama says he wants a moratorium on foreclosures. Would those proposals really help, or is this just campaign posturing?

WILLIAM RUDIN

There's no question we were in a very difficult place over the last few months. And unfortunately, it took time for the political system and government to react. The good news is they have reacted, and they've come up with a very, very strong plan. We could argue the merits of Senator McCain's or Senator Obama's plans. But the homeowner needs help, and anything that stops more inventory from coming onto the market would be very, very helpful.

Some people, such as Hillary Clinton, have suggested that it would have been better for Washington to have focused on bailing out homeowners instead of banks.
First you needed to restore confidence and liquidity. So you could help the homeowner, but if banks aren't lending to each other, aren't lending to consumers or businesses, then you could help all the homeowners you want, but if they don't have a job, it doesn't matter. You had to deal with the macro issue of providing liquidity to the marketplace.

"IF BANKS AREN'T LENDING...THEN YOU COULD HELP ALL THE HOMEOWNERS YOU WANT, BUT IF THEY DON'T HAVE A JOB, IT DOESN'T MATTER"

Obviously there are cities and regions harder hit by the real estate upset than others. Are there places where you think the housing market has actually bottomed out?
I'm not an expert on the national housing market, but I think it's a little too early to answer that question because nobody was able to borrow in the last 60 days. It's going to take a little bit of time for the positive things to start flowing. In the New York City market, there are still people buying, there are foreigners coming into the marketplace, even with the dollar strengthening a little bit. I think activity will pick up over the next 30, 60, 90 days.

New York Mayor Bloomberg announcing he will try to amend term limits

New York really is the eye of the storm in this financial crisis. Do you see a ripple effect on the real estate market from the layoffs at Bear, Lehman, and Merrill?
The full impact isn't clear yet. But let's take Lehman Brothers. They got acquired by Barclays. Barclays bought their building. Barclays is maintaining their investment bank and some of their other businesses. And so the initial thought was that there are going to be a lot of layoffs. But there haven't been that many layoffs yet. Our sense is a lot of those layoffs are going to happen outside of New York City, where there is redundancy in back-office operations.

What are you seeing on the front lines of commercial real estate in New York?
We're not seeing rents drop dramatically. We're seeing owners being more competitive in terms of pricing, but we're coming off of a very low vacancy level. We're below 6% right now. Even if we start seeing vacancies increase to 7% or 8%, it's still not significant. It's a 450 million-square-foot marketplace, so it's hard to give a specific answer as to what's going on. But there are people making commitments to leases.

Why hasn't the housing slowdown hit New York as hard as other markets?
New York has never been a speculative market like Las Vegas or Miami [page 51] or others where people would build condos and people would go in and buy them and flip them and not live in them. New York has always been a market where people buy their homes and live in them.

With all the money on the sidelines, when will the economy turn fast and furious on the upside?
Hopefully, it won't be fast and furious, and there will be an orderly process where people look at their assumptions and analysis. We have to sort of go back to the fundamentals of how we look at our businesses. When we moved away from fundamentals and started thinking everything was going to go up forever, that's when we got into trouble.

You've been a staunch supporter of Mayor Bloomberg. Why should we break the rules and let him run for a third term?
First of all, I don't think you're breaking the rules. The city charter allows for the City Council to change the term limits. There's sort of a misunderstanding by the public about what exactly is going on. Term limits don't allow people to make a choice, and our democracy is all about choice. Nobody is saying that by changing the term limits, Mayor Bloomberg is automatically elected mayor. He's got to go through the process and convince voters he's the right person to manage the city during a difficult time. The people will decide whether he is or he isn't. But not letting them have a choice is a mistake.

The fight over term limits has at times pitted Bloomberg and his allies against [Estée Lauder billionaire] Ronald Lauder, who spent a lot of money pushing through term limits years ago. Is this a case of two rich guys deciding how 8 million people will be governed?
No. The people—not the billionaires—will decide whether to elect Bloomberg or whoever the other candidates are. | BW |

Maria Bartiromo is the anchor of CNBC's Closing Bell.

DAVID GOLDMAN/POLARIS

FORGET ADAM SMITH. WHATEVER WORKS

Washington's partial nationalization of banks marks a fundamental shift in thinking about the relationship of the public and private sectors

By Pete Engardio

THE FUTURE OF KAPITALISM

On Oct. 11, amid a week of astonishing developments in the global stock and credit markets, Federal Reserve Bank of Dallas President Richard W. Fisher addressed the high and mighty of global finance in Washington during pivotal meetings of the Group of Seven and the International Monetary Fund. The gravity and complexity of the 15-month-old credit crisis called for action that transcended familiar ideological categories, he hinted, such as free markets vs. state intervention. Fisher even borrowed a Chinese proverb popularized by the late Chinese leader Deng Xiaoping: "No matter if it is a white cat or a black cat, as long as it can catch mice, it is a good cat."

Back in the late 1980s, Deng meant that China needed to abandon basic tenets of socialist orthodoxy that stood in the way of prosperity. In these tough times, the proverb resonates in another way. The Bush Administration, by committing $250 billion to buy equity stakes in a huge swath of the U.S. banking system and extending all manner of financial guarantees to depositors and money-market investors, has just violated some enshrined principles of American-style, free-market capitalism.

You might dismiss all this as extreme measures for extreme times, a pragmatic adjustment that will be quickly undone once order is restored. But the significance, not to mention irony, of a Republican Administration partially nationalizing the U.S. banking system cannot be overstated. It could well go down as an important turning point in postwar American economic history, the beginning of a fundamental rethink of the proper boundaries between the public and private sectors. "The pendulum between the state and markets is swinging back before our eyes," says Daniel Yergin, co-author of the 1998 book *The Commanding Heights*, which chronicled the triumph of market capitalism over state-led economics since World War II. "And it is happening a lot faster than anyone expected."

As America struggles to recover from the deep recession that likely lies ahead, a new economic model could take shape that would involve a great deal more than direct government involvement in the world of Wall Street. It could mean

A BIGGER ROLE

How public policy and tax dollars could affect private industry

REGULATION

In exchange for funds, banks face higher capital requirements and oversight of subprime lending. A new Congress could toughen rules on telecom, energy, and health care

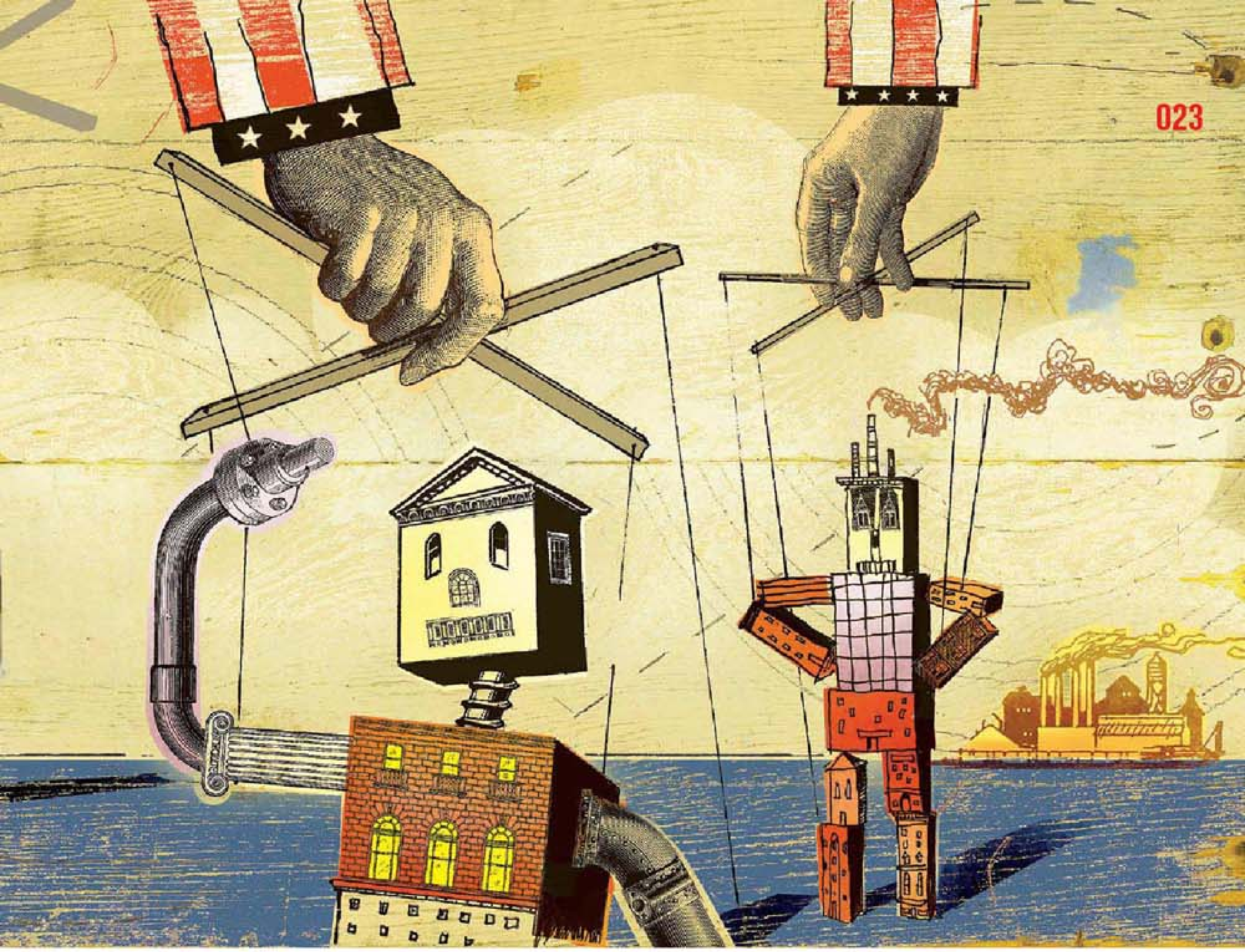
INDUSTRIAL POLICY

Federal bailouts will give Washington more say over Detroit's investment in fuel-efficient vehicles. Washington also could bankroll more investment in green technologies

ACTIVE STATES

New York, Pennsylvania, Oregon, and New Mexico are already investing in targeted industries such as semiconductors, renewable energies, and biotechnology

Data: *BusinessWeek*



greater support of such industries as autos, nanotech, and renewable energies, which face fierce global competition. And it certainly spells a return of heavier regulation. It is far too early to predict that the U.S. is headed down the road of Asia-style industrial policy or the kinds of interventions imposed during the Great Depression, when bureaucrats seized and micromanaged entire industries. The U.S. won't have voting rights on the preferred shares it bought in Bank of America, Citigroup, JPMorgan Chase, and others. And analysts doubt Washington will dictate lending. But as Yergin notes: "The political process has not even begun to get ahold of this." If Barack Obama wins the Presidency, possibly with a filibuster-proof majority in the Senate, the next Administration could have a mandate for sweeping change.

Unlike many other recessions, this one wasn't caused by a downturn in a few specific industries. It started with a housing bust and then metastasized into a full-blown credit crisis that eventually destabilized the entire U.S. financial system. As previous financial crashes in nations such as Japan and Mexico have shown, recovery can take years. "We will see de-leveraging on such a scale that we are in uncharted waters," says economist Hung Tran of the Institute of International Finance, a Washington think tank.

Government involvement may go far beyond the financial sector to include support for struggling industries

In fact, the crisis has been so devastating that once-cherished assumptions about the superiority of the U.S. economic model are now in doubt. Take the notion that the American economy could keep flying high as its manufacturing base withered. The idea presumed that innovation and productivity alone would create the wealth and high-paying jobs needed to boost U.S. living standards. The credit boom masked a troubling trend: Over the past decade, strong U.S. productivity growth has coincided with declining real incomes for most Americans (story, p. 34).

Nor has the faith in financial engineering proved justified. Through lightly regulated derivatives markets, banks could repackage toxic loans and send them into an ocean of investors ranging from pension funds to Chinese banks. And both households and companies went wild on debt. The IIF

Global financial leaders in Washington on Oct. 11

JONATHAN ERNST/REUTERS

estimates at least 30% of the $1.3 trillion in U.S. consumer debt, most of it on credit cards, is bad. Nor has the system sorted through the $1.7 trillion in high-yield corporate debt.

The new American reality will first manifest itself in greater regulation of finance. "The financial landscape is being redefined in fundamental ways," says Mohamed el-Erian, co-CEO of PIMCO, which is managing commercial paper assets the government has assumed. "There is no reset button." El-Erian is convinced the government, even under an Obama Administration, will not intrude in nitty-gritty management or loan decisions. He thinks lasting intervention will come in the form of higher capital reserve requirements and curbs on subprime lending and complex derivatives.

This financial reckoning will focus minds on rebuilding the U.S. manufacturing base. Here, too, government could play a huge role. That $25 billion bailout Congress has promised General Motors, Ford, and Chrysler likely will come with strings. The subsidies give Washington considerable leverage over Detroit on strategic matters. U.S. automakers will have to convince the Energy Dept. they will be able to boost fuel efficiency to at least 35 miles per gallon, for instance, by investing in facilities to make electric cars. Obama supports giving another $25 billion to Detroit. On top of that, he promises $150 billion in new spending on clean-energy technologies.

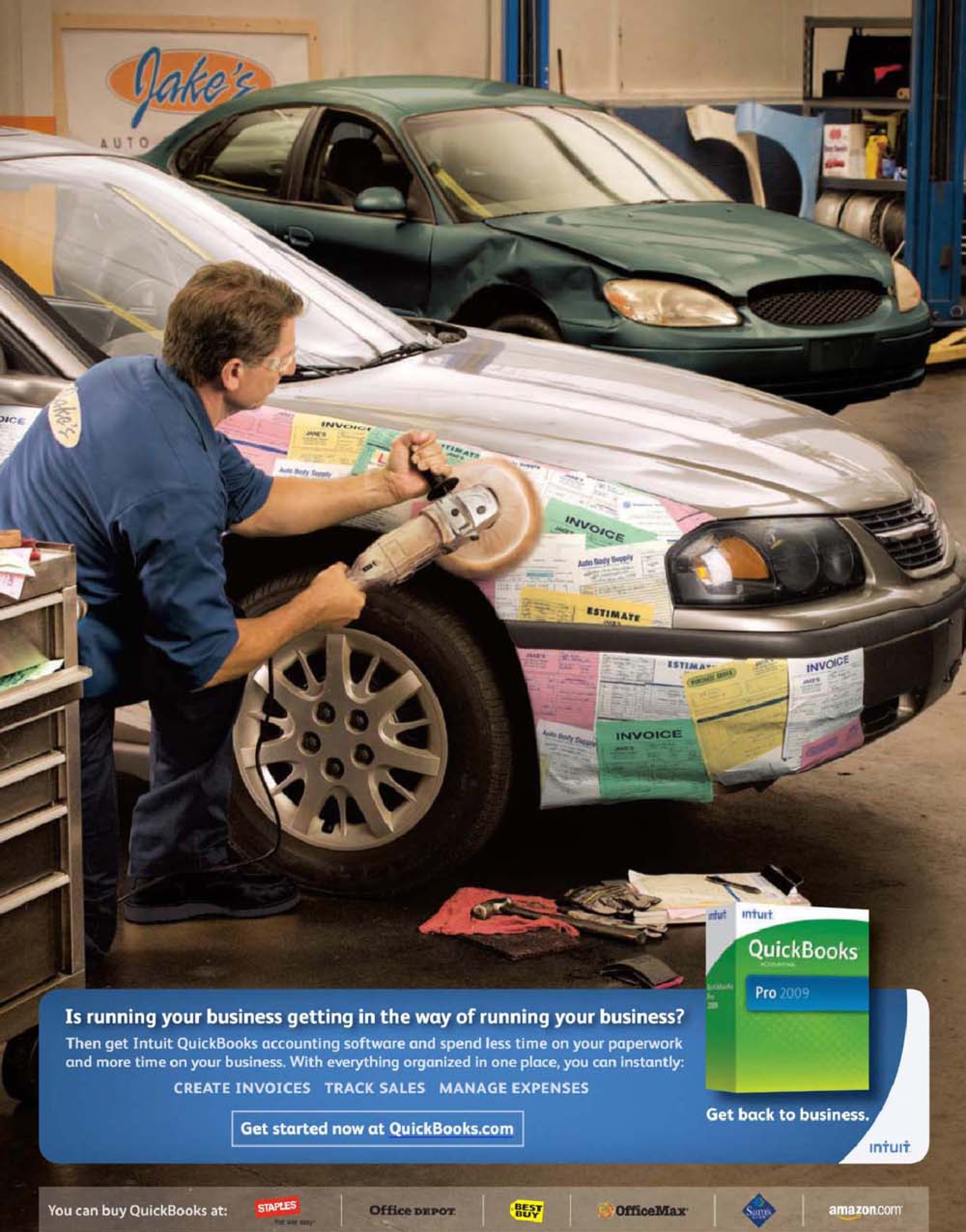
Washington's subsidies for automakers will give it considerable leverage over Detroit on strategic matters

SUSTAINABLE INDUSTRIES

Yet skip Washington for a second. Go instead to states such as New York, Oregon, Pennsylvania, and Texas, where governors, business leaders, and university deans have been leading efforts for the past decade to nurture new industries. States aren't just rolling out tax breaks and offering cheap land. They are adapting strategies from nations known for generous industrial subsidies, such as Singapore, Germany, China, and Finland.

A good illustration is Advanced Micro Devices, which on Oct. 7 decided to spin off its manufacturing operations into a new company in which the government of Abu Dhabi will own a 50% stake. The venture will build a $4.5 billion silicon wafer plant in Albany, N.Y. The state of New York, which already has invested more than $1 billion in nanotech research and development, worker training, and a state-of-the-art clean room in Albany, will kick in $1.2 billion in tax benefits and outright cash rebates to cover construction and equipment costs. For struggling AMD, one of the last U.S. chipmakers that still manufactures its own wafers, the financial help from New York and Abu Dhabi "was incredibly important," says AMD CEO Hector de J. Ruiz. Few private investors in the U.S. are willing to risk such huge sums on a high-tech plant that won't produce returns for at least five years. "In a large economy like the U.S., it is impossible to be successful and thrive if you do not make something, especially in industries in line with your core strengths. The government will have to realize it must play a role," says Ruiz.

Call it industrial policy, or use the euphemism of "public-private partnership." But as America emerges from the rubble of the credit bubble and soberly confronts the task of building a strong, sustainable economy, the new credo will likely be "whatever works." |BW|



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Is running your business getting in the way of running your business?
Then get Intuit QuickBooks accounting software and spend less time on your paperwork and more time on your business. With everything organized in one place, you can instantly:
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Protesters in Philadelphia call for more action on the subprime crisis

WAITING TO BE RESCUED AT HOME

Uncle Sam faces big legal obstacles in stemming the rising tide of foreclosures

By Jane Sasseen

THE FUTURE OF KAPITALISM

The financial system, perhaps, has been saved. Now, what about homeowners?

So far, attempts to slow the foreclosure epidemic at the center of the crisis have had little impact. Despite "voluntary" industrywide efforts to rework troubled mortgages—efforts that Treasury Secretary Henry Paulson jawboned banks and mortgage servicers into undertaking last fall—the numbers continue to soar. In 2008 some 1.69 million homeowners will lose their houses—double the rate of two years ago, says Rod Dubitsky, managing director for asset-backed securities at Credit Suisse. He thinks 3.6 million more foreclosures could pile up through 2012.

Both Presidential candidates now want the federal government to take a more active role in buying up troubled mortgages and helping homeowners refinance with more affordable loans. Congress has also insisted the Treasury do more. But many of the proposals, which are based on the Depression-era Home Owners' Loan Corp., are likely to run into the same legal woes that have stymied mortgage workouts so far. The government may have to find a more extreme legal solution to get mass workouts going.

The reason: No one has figured out how to untie the Gordian knot created by the mass securitization of mortgage loans. Hundreds of investors may own an interest in the trust that holds any given mortgage. If a loan is reworked, some of those investors would lose more than others. In many cases, mortgage servicers are prohibited from modifying a pool of loans without the consent of two-thirds of the investors; often, the servicers also earn more in foreclosure than in reworking a loan. "The servicer or the lender needs more flexibility to reach a rational economic decision," says John L. Douglas, chair of the banking and financial institutions group at law firm Paul, Hastings, Janofsky & Walker.

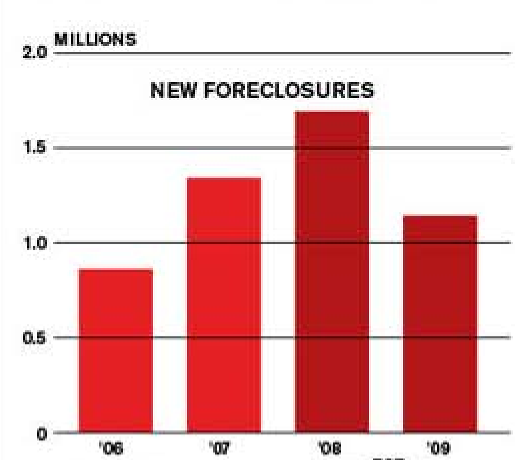
What might that mean? Douglas thinks servicers need protection from investor lawsuits. But others say the government may have to nullify or supersede some of their obligations or investors' rights. To give securities holders more incentive to loosen the trust rules that govern them, Georgetown University Law Center associate professor Adam Levitin argues that Congress could reduce the favorable tax status for trusts that don't go along. Or, he says, what's known as the Gold Clause could be invoked. Under this New Deal-era legal precedent, the government, citing the need to preserve gold because of the economic emergency, abrogated private contracts that required payment in bullion. Washington could use the Gold Clause to give trusts leeway to modify mortgages.

Those tactics could spark enormous litigation, however. Uncle Sam might also have to reimburse investors for lost value. That's why many argue it would be better for Congress to change the bankruptcy laws. Currently, homeowners who go belly-up cannot renegotiate their mortgages in court. Democrats have tried to alter the law so bankruptcy judges can trim interest or principal. "It gets around the biggest impediment to workouts without costing taxpayers a penny," says Jaret Seiberg, an analyst for the Stanford Group brokerage.

Republicans have blocked the effort, arguing that if courts were granted these new powers, lenders would see their losses soar and pass the cost on through pricier mortgages. But should foreclosures continue to skyrocket—and should Barack Obama, who backs the bankruptcy measure, be elected President—mortgage holders could find themselves on the losing end of the battle. | BW |

—With Theo Francis in Washington

THROUGH THE ROOF



Data: Credit Suisse

ADAM NADEL/POLARIS; CHART BY RAY VELLA/BW

DETROIT REVS UP FOR A BAILOUT, TOO

And given the Big Three's outsize role in the U.S. economy, it may make sense for taxpayers to ante up

COMMENTARY

By David Welch and David Kiley

The U.S. is spending massive sums to save the banking sector. And guess what? Detroit wants a bailout, too. Rarely a day goes by without lobbyists working for General Motors, Ford, Chrysler, and the unions pestering the Obama and McCain campaigns for a major rescue package. What has been unthinkable for eight years—Detroit could barely get President Bush to take a lunch date—is now decidedly thinkable. Barack Obama, who for months has called for the feds to double $25 billion in government loans to help the Big Three build green vehicles, is taking the appeals seriously. (McCain supports the original loan amount.)

Of course, Detroit is playing politics. Its hired guns point out that many auto plants are in battleground states—Ohio, Pennsylvania, Indiana, and Missouri. The lobbyists also are making the case that political peril will loom even after a new Administration takes office in January. If a domestic carmaker fails as the recession tightens its grip, they warn, sitting congressmen will pay in the 2010 midterm elections. Here's how one Detroit lobbyist puts it: "You don't want your guys in 2010 to own what could happen in 2009."

Let's set aside naked political opportunism. The lobbyists have a point. The Detroit Three may be too weak to survive what looks to be a deep and protracted downturn—even if GM and Chrysler merge, another once-unthinkable prospect that the two companies are seriously considering.

BILLIONS IN BENEFITS

The collapse of one, two, or all three automakers would cut a swath through the already struggling Midwest economy. According to the Center for Automotive Research, the domestic car companies and their suppliers employ some 600,000 line workers. Add in companies that indirectly rely on the industry for jobs, estimates the research center, and 3.6 million people potentially are at risk.

THE FUTURE OF KAPITALISM

There's more. If an automaker declared Chapter 11, taxpayers would be on the hook for billions in retiree benefits from that company. The trade deficit would balloon as foreign companies grabbed the domestics' customers. Sure, Toyota Motor and others would build more plants in the U.S., but much of the manufacturing and R&D would happen overseas. Finally, consider the reputational hit to a superpower that can't sustain a domestic auto industry.

Given the stakes, it's not hard to see why momentum for a bailout is building. Besides doubling the original $25 billion loan, Democrats seem willing to allow the Big Three to spend the money not just on developing fuel-efficient models but also on paying the bills while they fix their problems. The hope is that this will get the Big Three through 2009. By then, auto sales may have picked up and a new health-care pact with the United Auto Workers should help Detroit slash billions of dollars in costs. Assuming the companies are sufficiently healthy, they can then repay the loans with interest.

And if things get worse than expected? Industry insiders say the feds might need to take direct stakes in the automakers—as they're now doing with the banks. In exchange, Detroit could give the government stock warrants as Chrysler did when it got loan guarantees from Uncle Sam in 1979. No one wants to go there. But stranger things have already happened. | BW |

Fords in Missouri: The Midwest will be hit hardest if a carmaker fails

LARRY W. SMITH/GETTY IMAGES

IS DETROIT TOO BIG TO FAIL?

600,000*

Number of U.S. auto industry manufacturing jobs

*Includes suppliers
Data: Center for Automotive Research

UNDERWATER STOCKS, HIDDEN GEMS

Some shares are trading so low that they're selling for less than their company's cash assets

By Peter Carbonara, Arik Hesseldahl, and Tara Kalwarski

Looking for signs of value in the wreckage? By one measure at least, the stock market seems cheap.

A *BusinessWeek* analysis of stocks with a market value of $500 million or more found that 29 U.S. companies and 185 foreign ones were trading for less than the amount of cash on their books as of Oct. 14. At the depths of the last bear market—in October 2002—only 14 U.S. and 77 foreign companies fit the bill. Notwithstanding debt, investors are essentially pricing the companies as if their operations were worth zilch—an indication the stocks may have been oversold. "It's a tempting signal to buy," says Charles Wolf, an analyst at asset manager Needham & Co.

Famed value investor Benjamin Graham, who mentored Berkshire Hathaway's Warren E. Buffett, codified the use of this measure 80 years ago. During the Great Depression, Graham observed that a number of public companies were selling at a discount to their cash hoards, including auto- and truck-maker White Motor. When this happens, Graham noted in *Security Analysis*, the value investors' bible he co-authored in 1934, "either the price is too low or the company should be liquidated."

In the current bear market, the list is dominated by financials such as Morgan Stanley and Australia's Macquarie Group, which have been hit by the credit crisis. Others, including carmaker General Motors and airline UAL, are struggling amid industrywide downturns.

Whether such companies should be placed in the trash heap or the bargain bin depends on a number of factors. From an investment perspective, high debt load, for example, makes a company's cash position look less impressive. ADC Telecommunications has cash assets of about $657 million, in line with its market size. But the maker of electronics gear also has about $650 million in debt. A company spokesman declined comment, except to note that ADC plans to buy back $150 million of stock.

Another question is what counts as cash. Under accounting rules, certain short-term investments qualify as so-called cash equivalents. Earlier this year, a number of companies found that their cash hoards included auction-rate securities, some of which were stuffed with subprime loans and other toxic assets.

Cash can also disappear quickly. Cypress Semiconductor recently held $819 million in cash. But the tech company used some to make an acquisition and pay off debt. A spokesman says Cypress, scheduled to report earnings on Oct. 16, now has a cash position that amounts to less than half its $644 million market value.

If history is a guide, however, these types of companies may be poised to take off. After the dot-com bust, the 14 U.S. companies whose cash was worth more than their stock saw prices rise by an average of 66% over the next 12 months. The gain for the Standard & Poor's 500-stock index: 29%. |BW|

–With reporting by Ian Rowley in Tokyo

TRASH HEAP OR BARGAIN BIN?

There are 29 U.S. companies with a market value of $500 million or more trading for less than the amount of cash on their books

NAME	MARKET VALUE* MILLIONS	CASH** MILLIONS	COMMENT
Sanmina-SCI (SANM)	$563	$982	There's speculation that the struggling electronics manufacturer is in talks to sell itself to Flextronics
UAL (UAUA)	$903	$2,899	Like other airlines, UAL recently issued stock to raise cash
General Motors (GM)	$3,703	$19,356	The automaker, hurt by fuel prices and the sagging economy, has had merger talks with rival Chrysler
Morgan Stanley (MS)	$23,300	$23,702	The financial giant has been buoyed by a U.S. plan to inject capital into key banks

*As of Oct. 14 **Cash and cash equivalents reported in the most recent Securities & Exchange Commission filing Data: Capital IQ

PATRICK LEGER


Hitachi | true stories
THE RIPPLE EFFECT
hitachi.com/truestories
"Our volunteer work can never stop. It's not an option. We can't afford not to be in our communities."
Nadine Flores
Hitachi Community Action Committee
Southern California Region
It's no surprise that a company known for its technological innovation takes an equally innovative approach to social responsibility. At Hitachi, local employees make the call about where and how to effect positive change in their communities. Working from the ground up, their efforts cultivate an ongoing cycle of giving. Watch the many ways the men and women of one Hitachi Community Action Committee are making a real difference in Los Angeles, one neighborhood at a time.
Watch the documentary film series at hitachi.com/truestories
HITACHI
Inspire the Next

Brussels: Dexia once boasted about its swaps. The bank was just bailed out

GAMMA/ZUMA PRESS

A LETHAL LOOPHOLE AT EUROPE'S BANKS

Firms are being battered because they used AIG's complex financial instruments to skirt capital rules

By David Henry, Matthew Goldstein, and Carol Matlack

European banks didn't gorge on subprime assets as much as their U.S. counterparts did. So why do foreign lenders suddenly need a bailout? Their deals with insurer American International Group may offer a clue.

Before the financial crisis hit, AIG did a booming business in credit default swaps, complex instruments originally designed to protect lenders if borrowers fail to make debt payments. The biggest buyers were European banks, whose deals last year with AIG totaled a staggering $426 billion. But the banks didn't always buy the swaps as insurance against defaults—they often used them to skirt capital requirements. AIG declined to comment.

Under international regulations known as the Basel Accords, European lenders have to set aside a certain amount of money to cover potential losses. By owning credit default swaps, banks could make it appear as if they had off-loaded most of the risk of a loan to AIG or another firm, thereby reducing their capital needs. The perfectly legal ploy allowed banks across the Continent to free up money to make more loans. It was part of the game taking place across the global financial system. During the boom, firms seemingly created money out of nothing, propelling the markets to unsustainable heights.

Such excessive risk-taking has brought down several European lenders. Consider Dexia, which received an $8.7 billion bailout from regulators in late September. The Brussels bank boasted about its credit default swaps in a press release last year, saying that the deals "freed up regulatory capital." A Dexia spokesman now says the firm made little use of such swaps.

Another busted bank, Fortis, noted in a May 2007 investor presentation that it planned to use "capital relief transactions" to help fund its purchase of ABN AMRO assets. A Fortis spokesman says the bank didn't buy swaps to improve its capital position.

Until late 2007, AIG gave its deals with European banks cursory mention in filings. Then the insurer got smacked by subprime losses on unrelated transactions. After that, investors pressured AIG to come clean about all of its sophisticated deals. AIG officials said in a Dec. 5 conference call that banks using credit default swaps could set aside capital that amounted to only 1.6% of a loan's value, vs. 8% without.

European banks didn't tap only AIG. Bermuda's Primus Guaranty, a firm that sprang up during the boom, targeted European banks looking to game regulations. Philadelphia bond insurer Radian Group marketed "Basel-friendly" swaps. Says Daniel Gros, director of the Centre for European Policy Studies in Brussels: "Through adjustments, [banks] could convince regulators that there was low or no risk."

AIG's credit default swaps, though, delivered an extra dose of leverage to the financial system. Given its high credit rating, AIG could make deals that required it to put up a meager amount of collateral, or cushion, against losses. The upshot: AIG boosted lending with little money.

But the gambit worked only as long as AIG maintained its credit rating. If the insurer were downgraded, AIG would have to pony up more cash. Otherwise the deals would fail—and banks would have to raise capital or dump assets.

That very scenario started to unfold on Sept. 15 when AIG got downgraded. Within 24 hours, the Federal Reserve stepped in with an $85 billion bailout to save the company. These days, AIG no longer makes such deals. It's just another way credit is contracting as the financial system pays for the excesses of the past. | BW |

$426 billion

The dollar value of derivatives European banks bought from AIG for "regulatory relief"

Data: AIG

DANIEL ZEZELJ

AIG'S RIVALS SMELL BLOOD

Its competitors are courting the insurer's marquee clients, sparking a price war

By Nanette Byrnes

As American International Group's new chief executive officer, Edward M. Liddy, prepares to break up the embattled insurance giant, he has declared that one piece is not up for sale: commercial insurance. With its lucrative multimillion-dollar policies for some of the world's largest companies, the unit has long been viewed as AIG's crown jewel.

But the $52 billion business may be losing its luster. Customers are nervous about AIG's future, and competitors are rushing to capitalize on AIG's battered reputation amid an $85 billion federal bailout following massive subprime losses, and an additional infusion of $38 billion from the Federal Reserve Bank of New York to cover the company's other obligations. Industry headhunters say competitors are courting top AIG underwriters, who play a critical role in the relationship-driven industry.

The battle has already morphed into a price war. Insurance brokers whose clients' policies came up for renewal on Oct. 1 say AIG slashed premium rates by as much as 50% on key accounts, though the company says rates have not changed materially overall. Rivals are offering discounts of up to 20% to woo people away. Within the industry, AIG's air of desperation is palpable. "Competitors smell blood," says Cliff Gallant, an analyst with Keefe, Bruyette & Woods, "and they are trying to steal that business as quickly as they can."

Now comes the real test of AIG's viability as a force in commercial insurance. Jan. 1 is one of the biggest days of the year for policy renewals, and AIG may have to scramble to maintain market share. In a recent survey conducted by New York insurance research firm Advisen, 71% of respondents who are AIG commercial policyholders said they plan to get quotes from competitors when their policies renew. John Q. Doyle, CEO of AIG Commercial Insurance, acknowledges the pressure but insists that "client retention has remained strong." He says AIG continues to hold vigorous competitive advantages, including "our capacity for risk, underwriting quality, geographical spread, breadth of product, and service overall."

Still, customers are already exerting more sway in driving down prices. Lance J. Ewing, vice-president for risk management at Harrah's Entertainment, says a good chunk of the $100 million he pays in annual premiums starts to come up for renewal on Dec. 1. While Ewing won't say how much of that business is with AIG, he argues that Harrah's is "in a better negotiating place with AIG, and obviously we will use that to our advantage."

AIG's Doyle and his colleagues are struggling to keep the unit untarnished by AIG's larger problems. The commercial chief says he and his unit's chief financial officer, Robert S. Schimek, have talked to thousands of customers in person and by phone since the parent company took the rescue package on Sept. 16 to avert bankruptcy. Daily updates on press coverage are sent out from headquarters to prepare staff for customer questions.

But one of the biggest challenges is motivating AIG employees who have seen their stock options and retirement plans shrivel up. With all the uncertainty, Steve Grabek, who heads commercial insurance for AIG in the Midwest, admits that it's hard to focus on building the business: "My priorities have become much more short-term-focused, very immediate," Grabek says. "Not much of my time is spent on strategy for the second half of next year." |BW|

INSURANCE WOES

AIG's 2008 estimated property and casualty earnings

$5.6 billion

Decline from 2007

-47%

Data: Friedman, Billings, Ramsey

HOW TO GET GROWTH BACK ON TRACK

BACK ON TRACK

By Michael Mandel
Illustrations by Guy Billout

Fixing the worldwide liquidity crunch has revealed a deep-seated and disturbing problem: What looked like fast growth in recent years was in part an illusion created by excess borrowing

MANDEL ON ECONOMICS

Take a deep breath. The global bank rescue plan is in place, and though the stock market has dropped sharply, the world seems to have avoided another Great Depression for at least the next week or two. Now we have a moment to step back and assess how we got here and where we're going next.

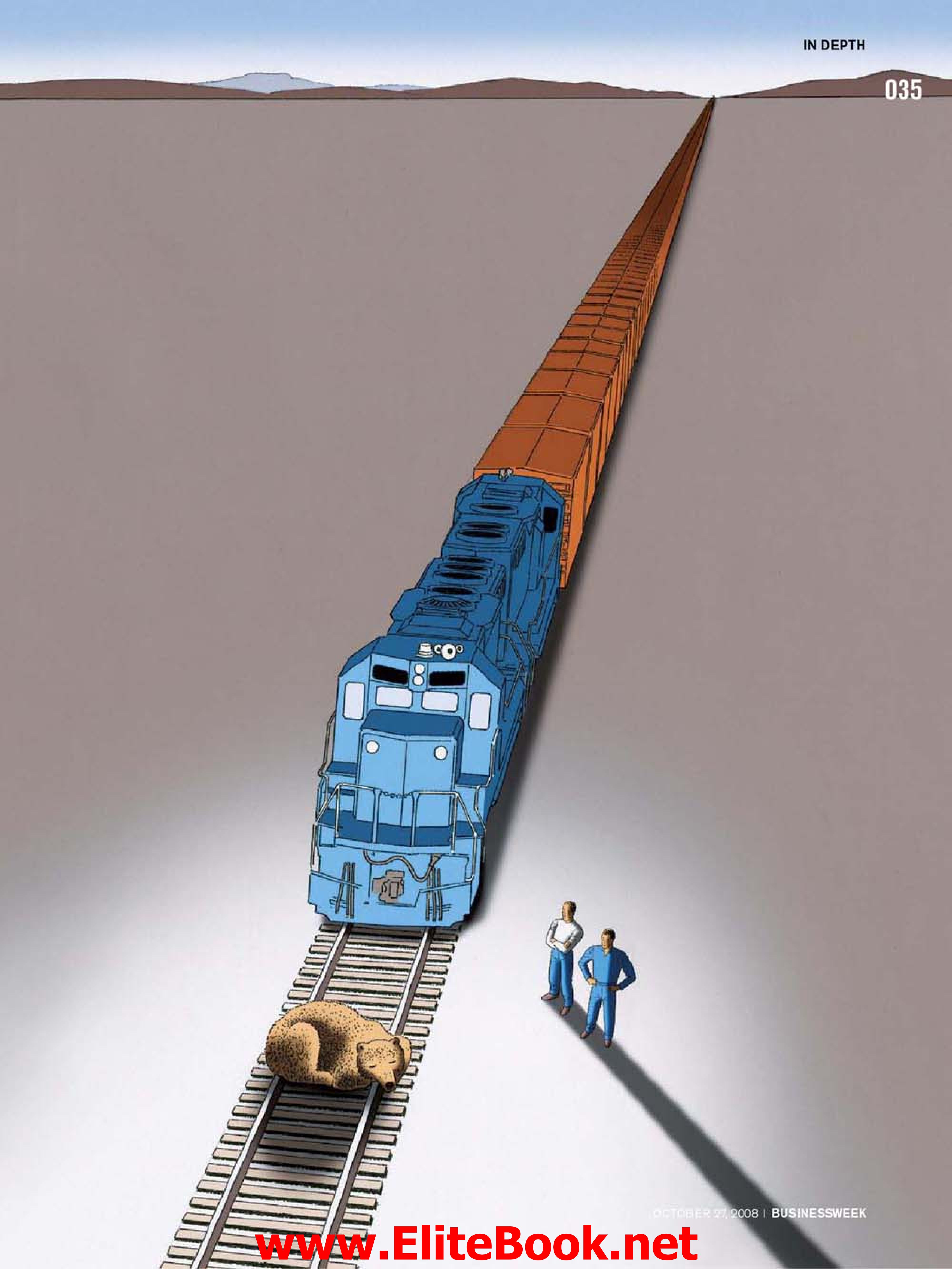
Let's put it this way: The U.S. and global economies were traveling at high speed along a clear track, like an economic bullet train, when we ran into the unexpected credit crunch. Yes, we took quite a bit of damage, but we didn't derail. Now we come to the big questions: Should we simply clear the track and fix the engine—that is, tighten up government supervision and improve financial regulation—and go on our way? Or were we on the wrong track to begin with?

The bursting of the credit bubble suggests that the U.S. and global economies have a growth problem as well as a debt problem. According to the official numbers, economic growth in the U.S. has averaged 2.7% over the past 10 years. But by *BusinessWeek*'s calculation, U.S. consumers have run up about $3 trillion in excess borrowing and spending over the same period—consumption that was not justified by income growth. Without that boost, which translated into new homes, cars, furniture, clothing, and the like, U.S. economic growth would have come in considerably lower. The global boom, too, was artificially fueled by out-of-control borrowing by consumers and businesses. "There was a sense of a bubble not just in real estate, but in that the underlying fundamentals were not supporting the market," says Michael Frantz, a Seattle-based managing director at project-management firm Point B, based on his conversations with clients.

OVER-RELIANCE ON OUTSOURCING

The upshot? A multitrillion-dollar bailout of the global financial sector will still leave us with sluggish growth. George Magnus, senior economic adviser to UBS, says the industrialized countries would do well to average 1.5% annual growth over the next five years, compared with 2.6% over the previous five. Magnus pegs world growth at 3% a year over the next five years, down from the International Monetary Fund's latest forecast of 4.3%. Those declines

PHOTOGRAPH BY BRAD TRENT



are the difference between prosperity and tightened belts.

Can the U.S. and global economies get off the slow-growth track? Yes, but it won't be easy. One key is that U.S. companies have to pay more attention to sustaining productivity growth and innovation at home rather than resorting to outsourcing as their main source of cost savings. That would boost wages and incomes for U.S. workers and reduce the need for the U.S. to take on huge debts to pay for foreign-made goods.

The good news is that the private sector may be moving in that direction already. Dan Warmenhoven, CEO of NetApp, a data storage company in Sunnyvale, Calif., says his customers are still buying, but they've shifted their behavior. "They are focused on making investments that reduce costs and increase efficiency," says Warmenhoven.

But the private sector can't do it alone. Policymakers around the world have to help, and that means doing more than simply fixing the global financial system. No matter how counterintuitive it seems today, with markets being bailed out by government action, China and other developing countries must take steps to encourage competition in their service sectors. Lowering prices would boost consumer demand and lessen the dependence of those countries on exports. And when the U.S. and other developed countries try to boost their economies by pumping up government spending, they must direct this fiscal stimulus toward spurring investment and innovation rather than consumer spending.

IMPROBABLE SURGE

In many ways, the strong period of growth that just ended was a surprise. After the dot-com bust of 2001, info tech investment plummeted in the U.S. and took years to recover. The fall of Enron, among others, led Congress to pass the Sarbanes-Oxley Act of 2002, an extra layer of costly regulation for businesses. On top of that, the 2001 terrorist attacks forced the country to spend hundreds of billions on security.

Despite that triple whammy, businesses continued to pump out big productivity gains—or so it seemed. According to the Bureau of Labor Statistics, output per hour rose by 2.1% from 2002 to 2007, a solid performance by historical standards. In the absence of strong investment, economists guessed that the gains were the result of companies learning to make better use of the info tech gear they already had.

Meanwhile, the global economy was undergoing its own improbable surge. Powered by China's expansion, global growth zoomed from an average of 3.1% per year during the 1990s to 4.6% per year in the five years from 2002 to 2007, its strongest showing since the late 1960s and early '70s.

But cracks appeared in the great growth trend as early as 2003. That's when real wages and salaries peaked in the U.S. From that point on, most workers saw their buying power drop. For example, adjusted for inflation, the usual weekly earnings of a worker with a bachelor's degree, supposedly a beneficiary of an information-driven economy, have fallen by 6% since 2003.

That drop in real wages offered the first clue that something was wrong. Historically, real wages have gone up in an economy with rising productivity. So either the productivity growth wasn't as strong as it looked or something else, perhaps competition from overseas, was holding down wages. In part, cost cuts from outsourcing were being reported as productivity gains because of a quirk in the economic statistics (BW—June 18, 2007).

In any case, here's where American lenders made their big mistake. When real wages started falling, they should have tightened their mortgage and consumer-credit lending standards and made it harder for households to borrow. Instead, they threw money at people whose real incomes were shrinking, not rising. Why did they do this? Greed, stupidity, and a genuine belief that a growing economy would enable Americans—even those with subprime loans—to pay back their debt. Under that scenario, the mountain of debt-linked securities would have been immensely profitable to financial institutions.

Looking back, it has become clear that rampant borrow-

WHICH NUMBER DOESN'T FIT?

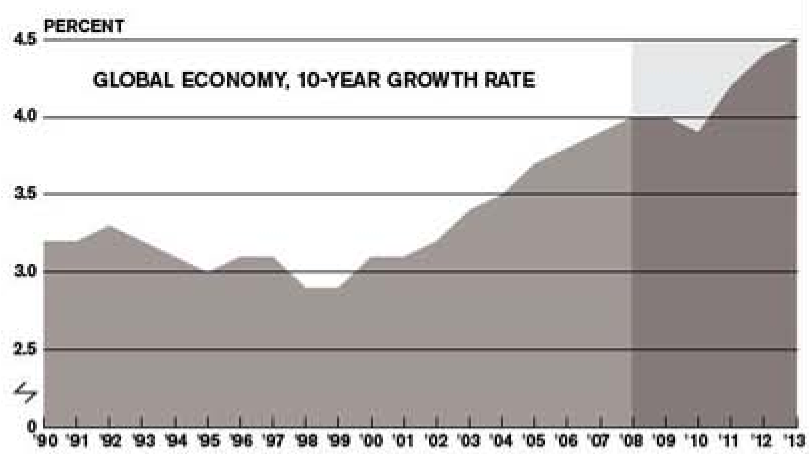
Over the past decade the government has reported a dramatic rise in productivity, which should have benefited workers or companies or both. However, the weak performances of wages and the stock market suggest that much of that productivity growth may have been a mirage.

Change over the past 10 years	
29.7%	Productivity
2%	Real Wages
-12.7%	Real Stock Market Return*

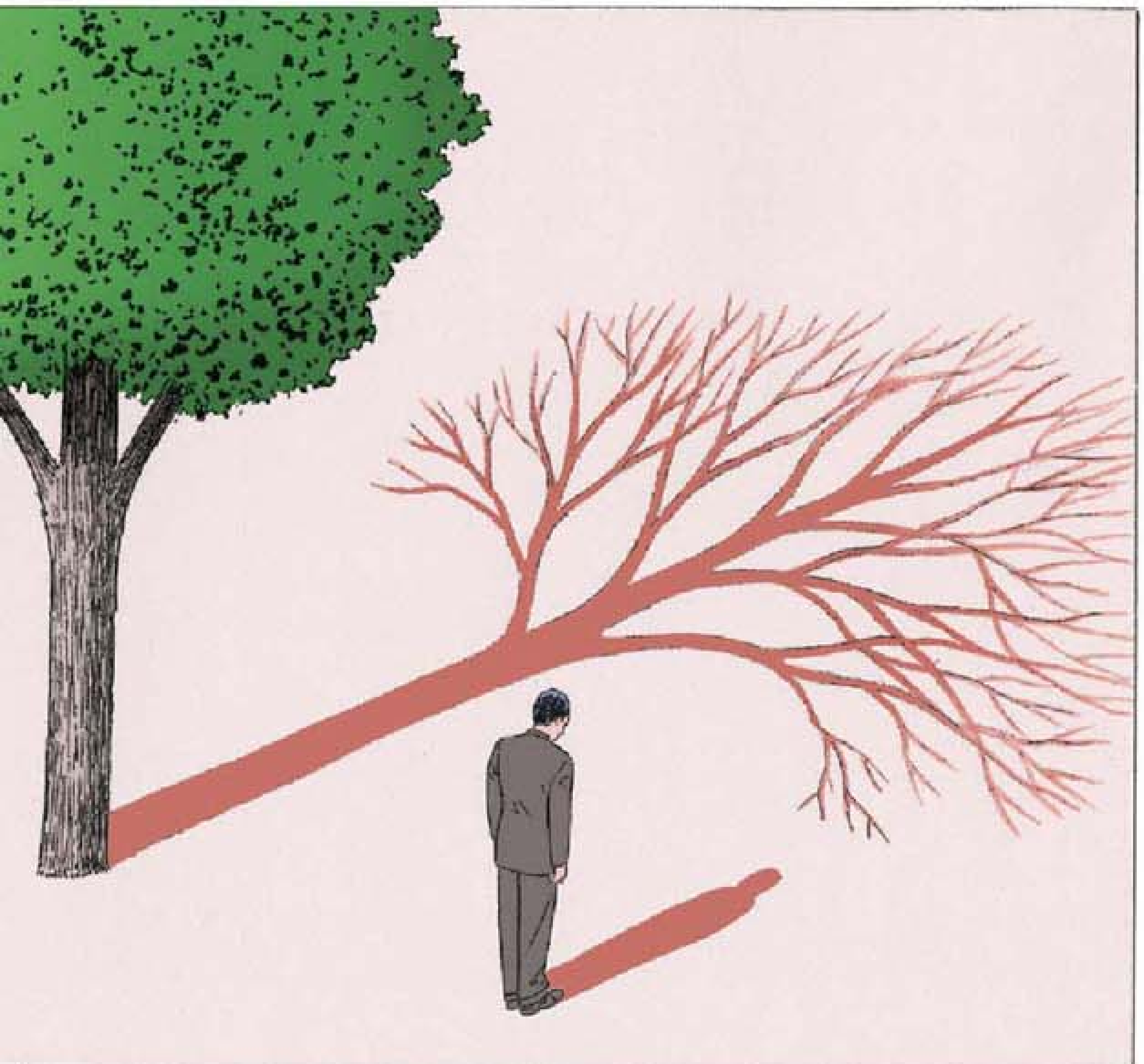
*S&P 500, including dividends, adjusted for inflation, as of Oct. 14
Data: Bureau of Labor Statistics, Bloomberg Financial Markets

OPTIMISTIC GROWTH PROJECTIONS

Why did people borrow so much? One reason is that global growth seemed to have no limits. Here are the International Monetary Fund's forecasts as of October 2008.



Data: International Monetary Fund



AMERICAN COMPANIES MUST FOCUS ON CREATING INNOVATIVE GOODS AND SERVICES THAT CAN BE PRODUCED IN THE U.S. AND SHIPPED ABROAD

ing and spending by U.S. households concealed fundamental weaknesses in the rest of the domestic economy. U.S. economic growth, outside of personal consumption, averaged only 1.3% per year in the 10 years ending in 2007, the slowest rate since the 1950s (chart). In other words, if consumption had not been pumped up by excess borrowing, the economy would have looked a lot weaker. From this perspective, the debt, like a fever, was a symptom of a deeper problem.

Not everyone agrees with this analysis. In a set of forecasts released in early October, economists at the IMF predict that global growth will return to 4% or greater after 2009. And Lexington (Mass.) forecasting firm Global Insight is still predicting long-term growth of 2.5% to 3% for the U.S. "If well handled, a financial crisis like this doesn't necessarily have a negative effect on long-term growth potential," says Nariman Behravesh, chief economist at Global Insight.

Others, however, believe the global economy has embarked on a long-term trend of slower growth, especially given the damage to the financial system and the need to finance the rescue. "There will be less innovation [in finance] and less credit expansion, so the speed limit for the growth of the economy will be lower," says Mohammed El-Erian, co-chief executive at Pimco, the giant bond-fund manager. "This will be the regime for several years." Adds Rajeev Dhawan, director of the Economic Forecasting Center at Georgia State University: "This credit problem, whenever it's solved, will have its fallout on the future growth rate of the economy. It is going to cost resources that could have been used for other things."

A CONTINUED SLIDE FOR OIL

Some economists have an even more dire view. In the near term, "it may not be as bad as people think. The economy may recover and governments still have some ammunition," says Masaaki Kanno, Tokyo-based chief economist at JPMorgan Securities Asia. But as growth bumps along the bottom, he notes, the economy will dip back into a downturn, just as it did in Japan—and governments will find it harder and harder to stimulate growth.

A slow-growth world has big implications for companies. For one, it's likely that the prices of commodities such as oil and copper, already well off their peaks, will continue to fall. In the past, oil had its sharpest declines in years when global growth was slowest.

Similarly, industries that require long-term investment—aircraft, semiconductors, and cars—may find themselves squeezed by slower long-term growth. Air travel, for example, and demand for airplanes are highly sensitive to a slowdown in global growth. Recent forecasts suggest air travel will grow at 4% to 4.5% or more per year over the next 20 years. But if those optimistic projections don't come to pass, demand for planes will slow, which will affect not only aircraft manufacturers but also major leasing firms such as International Lease Finance, a unit of American International Group, and GE Commercial Aviation Services, a unit of General Electric.

Similarly, sluggish auto sales, which go hand-in-hand with a slow-growth world, would be especially painful for Japan. Cars account for nearly 20% of the shipment value of Japanese manufacturing, and the auto industry employs about 8% of Japan's workforce. Unsurprisingly, Japan's exporters are hurting because of the slowdown in the world economy and the sharp appreciation of the yen. Even before the latest crisis, Toyota Motor projected that its operating profits will shrink 30% in fiscal 2008—the first drop in nine years. Given the global slowdown, Toyota may have to revise that projection downward.

Some companies are holding their plans steady, looking ahead to the post-crisis world. Samsung Electronics spokesman James Chung says the company has no plans to cut capital investments, research and development, or marketing spending. "We see the current crisis as an opportunity to expand our presence in an upturn," he says. Chung adds that Samsung is still seeking a $5.85 billion takeover of SanDisk, which makes flash-memory products.

One question is whether a global slowdown will hit industries that have been resistant to downturns in the past, such as medical care. An ominous sign: Royal Philips Electronics, one of the world's three biggest players in hospital and medical equipment, reported that a drop in orders for medical gear in the U.S. hurt the profitability of its normally strong medical business in the third quarter. "In the U.S. there is a higher dependence on capital markets at hospitals for their financing," said Chief Financial Officer Pierre-Jean Sivignon during the Oct. 13 conference call announcing third-quarter earnings. "With the financial crisis continuing, we have no idea how long this situation will persist."

WILL THE REAL U.S. ECONOMY PLEASE STAND UP?

Over the past 10 years, personal consumption growth has stayed strong while the rest of the economy has grown at the slowest pace in 50 years

Data: Bureau of Economic Analysis   *Through the second quarter

BEYOND FINANCIAL "INNOVATIONS"

One imponderable is the effect of slow growth on state and local governments. Tax-revenue growth will surely drop off as income and business-sales growth slow and property values decline. And big costs such as Medicaid will escalate as people lose their jobs and get bounced from employer health care rolls. But because they have the option to raise taxes and fees, state and local governments will feel less of a pinch from a slowdown than the private sector will, argues W. Bartley Hildreth, a public finance expert at Wichita State University.

Several things need to happen to get the economy off the slow-growth track. First, the private sector in the U.S. must concentrate on generating more productivity gains at home. In recent years, American multinationals took advantage of globalization to move more and more of their operations abroad. That made sense for the companies, but it created an unsustainable situation in which the U.S. had to keep borrowing from overseas to buy the goods made overseas. That accounted for a big portion of the excess-debt problem.

In addition, U.S. companies need to focus on creating more innovative goods and services that can be produced in this country and shipped abroad. Alas, in recent years the best examples of such exportable "innovations" were new financial instruments such as credit default swaps. The U.S. isn't likely to be exporting that sort of thing anytime soon. What's needed is more breakthroughs in areas such as biotech and energy.

Equally important, policymakers need to think beyond responding to the immediate crisis. Sure, fixing the financial system is essential to prevent demand for goods and services from collapsing, since many consumers and businesses need short-term borrowing to stay afloat. In that sense the solutions to today's crisis echo those of the Great Depression, when factories were idled because of lack of demand.

But unlike the Great Depression, there's a problem on the supply side of the global economy as well—one that requires a different policy response.

In particular, the location and mix of production has to change. Developing countries, with China as the leading example, must build up their ability to supply consumer goods and services to their own populations. "If we do not expand domestic consumption, it is highly likely that gross domestic product growth will be severely limited," says Cao Xuefeng, an economist at China Jianyin Investment Securities in Beijing.

In China, part of that effort requires additional reforms in the service sector, which won't be easy. "The key is for all the innovation, competition, and copying that has taken place in the manufacturing sector to be allowed to break out in services—things like health and education, telecom and finance, law and media," says Stephen Green, head of research for China at Standard Chartered Bank. "If manufacturing slows, only services can provide the employment and productivity you need to grow fast sustainably."

The other half of the equation: When the U.S. government undertakes fiscal stimulus measures, as it inevitably will, the money should be directed toward funding infrastructure, education, and innovation rather than consumer spending. Politically, maintaining a focus on investment and innovation in the U.S. may be almost as difficult as China opening up its service sector to international competition.

In the end, we may look back at fixing the banks as an easy task compared with changing the direction of national economies. As Japan discovered in the 1990s, notes JPMorgan's Kanno, "until the people really feel the pain, it's difficult to implement the radical policies." Let's hope we move more quickly this time. | BW |

—With Peter Coy in New York, Ian Rowley in Tokyo, Kerry Capell in London, and Chi-Chu Tschang in Beijing

WHEN WASHINGTON UNDERTAKES FISCAL STIMULUS, AS IT INEVITABLY WILL, THE MONEY SHOULD BE DIRECTED TO INFRASTRUCTURE AND EDUCATION

1

A pile of old monitors at a Supreme warehouse in Lakewood, N.J.

REDUX

THE DIRTY SECRET OF RECYCLING ELECTRONICS

By Ben Elgin and Brian Grow
Photography by Mark Asnin

Lax rules and enforcement allow scrap firms to profit by sending e-waste overseas

Business is booming at Supreme Asset Management & Recovery, one of the nation's largest recyclers of electronic waste. Inside a cavernous warehouse in the industrial section of Lakewood, N.J., workers in T-shirts grapple with newly arrived truckloads of old computer monitors, keyboards, printers, and TVs: tons of e-waste that contains dangerous lead, mercury, and cadmium. Such major manufacturers as Panasonic and JVC and municipalities like Baltimore County, Md., and Westchester County, N.Y., have paid Supreme to dispose of their digital detritus, relying on the company's assurances that the work is done safely.

But as the e-waste industry proliferates—some 1,200 mostly tiny companies generated revenue of more than $3 billion last year—it has also become enmeshed in questionable practices that undercut its environmentally friendly image. Next year the volume of e-waste will probably surge. In February, U.S. consumers must switch from analog to digital television service, a move that is expected to result in the mass junking of analog TVs.

Supreme, founded and still run by a man who pleaded guilty in 2001 for his role in a computer-theft ring, maintains that it lawfully disposes of e-waste after neutralizing all hazardous contaminants. But a recent probe by the U.S. Government Accountability Office found that "a large electronics recycler in New Jersey"—which *BusinessWeek* has identified as Supreme—was one of 43 U.S. companies that sought to sell e-waste for export to Asia, in apparent violation of the law. In China and elsewhere, electronic gear commonly is stripped for reusable microchips, copper, and silver; dangerous metals are dumped nearby, often close to farms or sources of drinking water.

Supreme doesn't dispute that it is the New Jersey recycler mentioned in an August GAO report about the investigation. But it denies any wrongdoing.

BusinessWeek independently found postings on China-based Alibaba.com

and other international trading Web sites in which individuals identified as sales representatives for Supreme and affiliated companies offered to sell scores of shipping containers filled with monitors of the sort that the U.S. Environmental Protection Agency has barred from export without special permission—which Supreme doesn't have, according to government records. "These monitors are all located in my N.J. warehouse and are ready to ship!!" one post said. A 40-foot-long container filled with monitors and TVs sells for as much as $5,000 in Hong Kong, according to e-waste recyclers.

Since the early 1990s, an international agreement known as the Basel Convention has restricted trade in hazardous waste, but the U.S. has failed to ratify the pact. As one limited response to the Basel initiative, the EPA adopted civil rules that went into effect in January 2007 forbidding U.S. companies from exporting monitors and televisions with cathode-ray tubes unless they have approval from the EPA and the receiving country. CRTs electronically project images on screens that are typically made of leaded glass. The gear contains mercury, cadmium, and other toxins that when released carelessly can cause neurological damage in children, among other harmful effects. The blood of children in rural Guiyu, China, a notorious e-waste scavenging site, contained lead at twice the acceptable level set by the U.S. Centers for Disease Control & Prevention, according to a 2007 study conducted by Shantou University.

"NO ACCOUNTABILITY"

Seven former Supreme employees told *BusinessWeek* in interviews that they knew about the company selling large monitor shipments overseas. Despite the sales offerings on the Internet and the accounts of its former employees, Supreme says flatly that it "is not an exporter" of e-waste. The phrasing of its statement leaves open the possibility that others export the materials. But Supreme adds that to its knowledge, all of its buyers behave lawfully. "We're doing everything we can to play by the law, to save the environment, and to run a successful business," says Brianne Douglas, vice-president of marketing. She adds in an e-mail: "Unlike some competitors, we don't simply buy and drive goods to the dock to be shipped overseas.... Items that are not reusable are broken down to a commodity level and everything—100%—is recycled."

Without commenting on Supreme's practices, some of its rivals confirm the GAO's findings that the e-waste business is rife with corner-cutting. "Ninety percent of electronics recyclers are cheaters," contends Robert Houghton, president of Redemtech, an e-waste processor in Columbus, Ohio. "This industry has a tradition of no accountability."

Thomas L. Varkonyi, proprietor of Metal Recycling in El Paso, says that Houghton's assessment applies all around the country. Varkonyi's scrap shop does a brisk business in e-waste trucked to him by recyclers. He, in turn, ships monitors and motherboards a couple of miles south to Juarez, Mexico. There, Mexican workers—"cheaper labor," he says—pry the e-waste apart, plucking out valuable metals and components that can be sold to international buyers.

Regulation of the unwanted toxins is far more lenient in Mexico. "If you wanted to break those rules, it would be easy because you can pay off anyone [in Mexico]," says Varkonyi. Nonetheless, he says he brings salvageable material and contaminated scrap back to his El Paso facility. As a result, he says, he doesn't need permission from the EPA or Mexican government. The EPA disagrees; activities such as Varkonyi's do require approval, the agency says.

(TOP) MATTHEW MAHON

Varkonyi, 63, describes himself as a middleman for recyclers who, he says, want to tell their corporate and municipal clients that they don't export PCs or other potentially hazardous gear: "I buy stuff from other recyclers who

Varkonyi buys gear from recyclers, then ships it to Mexico for stripping

then claim that they do not export anything." Varkonyi won't name his customers.

Sixteen years ago, Supreme Asset Management's corporate predecessor was started by Albert Boufarah, a man who went on to compile a colorful résumé in the computer-parts business. In the 1990s, Boufarah, a former organizer of computer trade shows, became involved with a loose-knit group of people who stole electronic equipment worth millions of dollars, according to federal law enforcement officials. Boufarah's role was to sell laptops and other stolen gear, says James M. Maxwell, the special agent with the FBI who arrested him in 1999. Boufarah cooperated with prosecutors and pleaded guilty to conspiring to possess stolen property. He received two years of probation. More than a dozen people were convicted.

Boufarah, 41, remains president and owner of Supreme. The company didn't make him available for an interview. In a statement, Supreme said that Boufarah was "unknowingly engaged with an individual who was dealing in stolen property. We resolved this problem quickly and appropriately, ensuring that the original victims received some reimbursement for their goods."

Supreme has grown from a handful of employees in the late 1990s to more than 100 today. Its facility in New Jersey encompasses 100,000 square feet. Rows of old monitors bound in plastic shrink wrap stand seven feet high. In the executive offices, a marble lobby floor and wood-paneled conference room exude an air of corporate success. Affiliated companies in Virginia, Maryland, and Massachusetts accommodate clients in those states, including Massachusetts Institute of Technology. Supreme says it processes more than 100 million pounds of e-waste a year. The trade magazine *Recycling Today* ranked it No. 2 in the industry in size. But the privately held company wouldn't disclose its financial results.

Like most of its rivals, Supreme charges clients several hundred dollars for carting away a shipping container of e-waste. The company promises to break apart the old equipment and dispose of the dangerous ingredients through a variety of methods, from unscrewing computer units by hand and prying loose circuit boards to cleaning leaded monitor glass in an expensive machine. Supreme says it sells the remaining glass, plastic, aluminum, copper, and steel for reuse.

PROFITABLE EXPORTS

It costs several hundred dollars, including freight and labor, to properly disassemble and recycle a container filled with toxin-laden monitors or TVs, industry executives say. Done domestically, that activity typically isn't profitable. But some companies engage in it as a loss leader, hoping to win lucrative contracts for recycling less toxic circuit boards and cell phones. Exporting e-waste offers a different route to making money. In Hong Kong, the e-waste import center of Asia, a container of unprocessed monitors and TVs that sells for $5,000 can net profits of $4,000, according to people familiar with the trade.

Although it claims otherwise, Supreme appears to be active in the export market. In one message in September on Alibaba.com, Matthew Evans, identified on the site as a Supreme sales manager, said: "We have in stock and ready to ship 20 containers of tested, working [monitors], 1997+ and 10 containers of tested, nonworking." In an April posting, Scott Applegate, listed as international sales manager for Reusable Assets, a company that former employees say is affiliated with Supreme and operates from the same New Jersey address, offered to sell 10,000 nonworking 15-inch computer monitors. "We have more than 100,000 sq. ft. of warehouse space in Lakewood, N.J., loaded with merchandise ready to sell and ship at all times," his message read. Evans and Applegate are listed in Supreme's phone directory, but couldn't be reached for comment.

As part of their investigation, GAO employees posed as foreign buyers of U.S. e-waste, including CRT monitors, which under most circumstances would be illegal to export. Of the several offers from the New Jersey company that *BusinessWeek* has identified as Supreme, one sought a buyer for 60 large containers

WHAT INVESTIGATORS FOUND

U.S. Government Accountability Office operatives posed as unscrupulous foreign e-waste buyers

EAGER SELLERS
Numerous U.S. companies, including some extolling their green practices, offered to sell e-waste for export, in apparent violation of American law.

INEFFECTIVE RULES
U.S. Environmental Protection Agency regulations are too narrow; the rules don't cover digital refuse other than that from old computer monitors and TVs.

SLACK ENFORCEMENT
EPA enforcement is "lacking." The agency says it has focused on "educating" regulated companies rather than on policing them.

Data: GAO

Supreme's customers have included Panasonic and JVC

of used TVs—perhaps 48,000 units in all—the GAO said in its August report.

Many of the 43 U.S. companies that expressed willingness to export items to the GAO undercover buyers "publicly tout their exemplary environmental practices," the report noted. On its Web site, Supreme says that "100 percent of the electronic waste we receive is reused or responsibly recycled."

The GAO stressed that the EPA's rules and enforcement efforts are inadequate because they focus only on CRTs, ignoring the export of other potentially hazardous electronic parts. The EPA has done relatively little enforcement, the GAO added.

DANGEROUS BATTERIES

The EPA counters that it has focused on educating e-waste recyclers about the CRT rule and now is stepping up enforcement. In August the agency fined Chino (Calif.)-based Jet Ocean Technologies $32,500 for shipping a container of scrap monitors to Hong Kong. "We want to encourage safer recycling," says EPA spokeswoman Rosemarie Kelley.

E-waste dumping is a growing problem not only in the developing world but also in the U.S. In October 2007 a Supreme affiliate disposed of 37 tons of refuse that contained lithium batteries at the King and Queen Sanitary Landfill in Little Plymouth, Va., according to a written description of the subsequent cleanup by Golder Associates, a consulting firm in Richmond. Lithium batteries, which are used to power laptops and other portable devices, are not supposed to be dumped like regular garbage, in part because they can ignite when exposed to water as they corrode. A related danger is that landfills produce large amounts of flammable methane gas. Supreme dispatched workers to the Little Plymouth landfill to collect the batteries, which filled up three 55-gallon drums, according to Golder. Supreme denied that it ever disposes of lithium batteries at landfills but said it helped clean up the batteries dumped in Little Plymouth.

Supreme's customers say they believe the company handles their e-waste properly. MIT, Baltimore County, and JVC all explain that they have visited Supreme's premises and observed nothing inappropriate. "Everything gets broken down at their facility," says Ed Nevins, director of environmental affairs at JVC. Panasonic said that it worked with Supreme on a single e-waste collection drive last year.

Norman Magnuson, director of operations for MIT's facilities, says that Supreme routinely provides a "certificate of proper destruction," indicating that the university's e-waste doesn't get sent overseas. "They assure us," he adds, "that everything is recycled in a safe way." |BW|

–With Ellen Gibson

BUSINESSWEEK.COM | For an account of allegedly dangerous working conditions in the e-waste recycling business, go to businessweek.com/go/08/ewaste

Business Exchange

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African Dumping

Toxic electronic waste from the West is turning up all over the developing world, including Africa. British newspaper *The Guardian* earlier this year spotlighted the thriving e-waste trade in Lagos, Nigeria, and Accra, Ghana, where toxic dumps of discarded electronics have sprung up. Children burn and pull apart the equipment to extract metals that can be sold for cash, the paper reports.

For more of the *Guardian*'s coverage, go to http://bx.businessweek.com/globalization

'DO I LOOK LIKE A CEO?'

Bram Cohen has Asperger's, which makes it hard to deal with everyday life. Even so, he started his own company, BitTorrent

By Susan Berfield
Photograph by Eric Millette

Bram Cohen's brain works differently from most people's. He has Asperger's syndrome, a condition that keeps him rooted in the world of objects and patterns, puzzles and computers, but leaves him floating, disoriented, in the everyday swirl of human interactions. ¶ When Cohen was in his late twenties he sat on a wooden chair with a Dell keyboard on his lap for the better part of nine months writing a software program. In 2001 he introduced BitTorrent, an ingenious, disruptive, and controversial piece of technology that is available for free and lets people easily exchange huge amounts of digital information, from software upgrades to videos. Pirated movies have always been the most popular files shared. They, along with more legitimate files, now generate about half of all traffic on the Internet.

BitTorrent brought Cohen fame and notoriety. It turned him into a folk hero and a Hollywood villain. Later, to reclaim the program for himself and possibly for some greater good, Cohen was obliged to become something else he had never considered: a boss. Four years ago, at age 29, he co-founded a company, BitTorrent, to build a business around his software. He got good money from venture capitalists but is still trying to find a convincing strategy.

For Cohen, this has been a fraught journey into the sometimes bewildering world of the office. The social conventions that ease everyday interactions can still elude him. He doesn't like to shake hands or wear shoes or make small talk. He often plays with a Rubik's Cube. Sometimes when he is outraged, or more often when he is fatigued, he bursts forth with unwelcome candor. He can be oblivious, lecturing on solar cells or economic theory or euphemisms until someone stops him.

Cohen's predicament is not so unusual. Asperger's, only formally recognized in the mid-1990s, is being diagnosed with increasing frequency. Many psychologists view it as a mild form of autism, though that definition is controversial; some advocates believe it is simply a different way of being. In the coming years more people like Cohen will arrive in the workplace, and their presence will have significant consequences, perhaps most obviously in the way we communicate.

Cohen's childhood in Manhattan was one of isolation. He lived comfortably enough with his mother and father and younger brother, Ross, and they shared a vigorous intellectual life. But he had no friends. At 16, he could program in three languages. Yet he could not comprehend the social hierarchies of adolescence. "I was picked on a lot," he says. "There was something obviously wrong with me. But it wasn't acknowledged until I was much older that something had always been off-kilter. Were I to have to redo high school, I would just drop out immediately." He attended the State University of New York at Buffalo for one miserable year and then left.

"THIS IS STUPID"

Back in Manhattan, staying with his parents, he struggled in the working world as a computer programmer. "At first he would be enthusiastic, and then pretty soon he would tell the people who were running the startup they were doing things wrong," says his father, Barry, a writer who had returned to school to study computer science. "If they didn't listen to him—and they

Cohen in San Francisco, where his quirks aren't seen as a big deal

never did—he would say 'this is stupid' and he would quit."

By 1997 the code rush was on, and Cohen went west. In San Francisco he felt at ease, and even a bit elated, surrounded by other computer geeks. Here his trouble deciphering human complexities, his seeming indifference to social imperatives, and all his quirks of character were mostly viewed as beside the point. The point was what he could accomplish. In this, Silicon Valley is not as distinct a place as it might seem. Psychologists have noticed clusters of people with Asperger's wherever there is a concentration of high-tech companies.

It took Cohen a few years and several more startups before he discovered what he wanted to do: find an efficient way to share huge amounts of digital data. Napster and other peer-to-peer programs already allowed people to pass smaller music files from one computer to another. But big files would clog the system. The elegance of Cohen's solution is that as more people join a network, data move faster rather than slower. His software breaks files into pieces and scatters them on users' hard drives. When someone requests a movie, the software gathers the pieces from the nearest computers on the network and assembles them only once they reach their destination. This allows a file to download much more quickly.

Cohen was surprised that BitTorrent ushered in the golden era of movie piracy. "I was some dude working on some project," he says. "I couldn't anticipate the piracy. But I was very careful from the beginning to distance myself from it. There's only so much planning you can do for the effect on the Internet at large when you're just trying to get people to use your software."

LEARNING EMPATHY

Cohen mostly enjoyed his newfound status. And it was amid this success that he was able to put a name to his lingering complaint. One afternoon in the summer of 2003 he was eating at a Mexican restaurant in Berkeley with his girlfriend, Jenna, and her young daughter. They were talking about empathy, a notion that baffled Cohen. "Then a baby cried, and my daughter turned and made a sad face," Jenna recalls. "He said, 'You mean like that?' I said, 'Yes, it's automatic.' " Not for Cohen, though, who told her that emotions seemed mysterious. Jenna, who had worked with autistic kids, suggested he might have Asperger's.

Cohen never sought a formal diagnosis but turned his considerable attention to the matter. He learned how to detect and mimic human expressions, follow social cues, maintain eye contact, flirt. He began pretending to be normal. "Then I realized how out of it I had been my entire life," he says. Jenna likens Bram to the android Data on *Star Trek*: "He'd add information to his social algorithm and practice until it became natural. He's graduated to being an eccentric nerd."

During the next year, Jenna and Bram had a son and were married. Cohen's father began pestering him to create a company around his hugely popular software. "And I kind of felt like I should do something," says Cohen, who was moving among various projects. A friend introduced him to Ashwin Navin, who had worked at Goldman Sachs and Yahoo!, and along with Cohen's brother, they formed BitTorrent. Then they set out to make peace with the movie studios and bring in investors. In May 2005 pirated versions of the much-anticipated third *Star Wars* movie, *Revenge of the Sith*, were being swapped before the official release. Shortly after, Dean Garfield, the head of legal affairs at the Motion Picture Association of America, approached Cohen and Navin to see if they were serious about going legitimate. They began talking. In November of that year, BitTorrent and the MPAA announced a deal that was largely symbolic but did improve the company's reputation in Hollywood: BitTorrent agreed to remove links

BitTorrent President Navin (left) worked with Cohen to make peace with Hollywood

MARKHAM JOHNSON

that directed users to pirated movies. Cohen doesn't like to travel, but he went down to Los Angeles for the day.

Cohen and Navin also were meeting with venture capitalists. David Chao, a co-founder of DCM, a $1.6 billion fund, had been using the software to share family videos and was intrigued by it. Cohen arrived at Chao's office for an initial presentation, took off his shoes, and announced that he had Asperger's. "It's one of the first things he tells most people," says Chao. "He wants to make sure there are no misunderstandings." Cohen said he wanted to run the company, mostly because he didn't trust anybody else to, but promised he'd one day bring in a more experienced leader. Navin would be president. Chao agreed to invest $8.75 million. At the first board meeting, Cohen worked on a Rubik's Cube while he was talking, recalls Chao. "He wasn't distracted, though. His hand was solving it." With someone else, Chao says, he might have said, "Please don't play games while we're having a board meeting," but he didn't.

As Cohen and Navin began hiring employees, issues emerged. Ross, who was in charge of the engineers, didn't seem suited to the more structured environment being created. Bram fired him. "He just didn't work out," says Bram. The brothers haven't spoken much since, and Ross didn't return phone calls and e-mails.

Then there was Bram himself. He could be disruptive. He likes to talk and play with his puzzles. "We have to keep him contained so others can work," says Navin. "New employees didn't know they could tell him they had to get back to work." And his overly blunt but rarely ill-intentioned comments didn't always go over well. Ivy Hsu, the office manager, was the first person Cohen and Navin hired. One day Cohen said to her: "I don't understand the point of being detail-oriented.

COHEN LIKES TO TALK AND PLAY WITH HIS PUZZLES. "WE HAVE TO KEEP HIM CONTAINED SO OTHERS CAN WORK," SAYS NAVIN

Only the dumb people in this world focus on small details." Hsu has since learned how to deal with him. "You have to communicate according to the rules he understands," she says. "You can cut him off, you can walk away. There is no point in sugarcoating things, because if you do, he may miss the whole point. You just tell him: 'Bram, you're wrong. Bram, don't say things like that.' Usually you would never do that to your boss."

By the end of 2006 it was clear that Cohen's days as CEO were coming to an end. Some founders unprofitably delay this rite of passage. For Cohen, it couldn't come soon enough: "Do I look like a CEO to you? Just saying." BitTorrent was ready to sell a commercial version of the software to media, gaming, and tech companies and to launch a consumer site with licensed content. Navin and Cohen had also interested another investor, Ping Li, a partner at venture capital firm Accel, an early backer of Facebook. Li agreed to put in nearly $20 million to help BitTorrent expand. There would be accounts to supervise, strategies to devise, performance reviews to conduct, meetings to attend. Cohen was bored just thinking about it all.

Giving up the post of chief executive to become chief scientific officer wasn't hard for Cohen, but the nine-month search for his replacement, led by the recruiting firm Heidrick & Struggles, was full of frustration. After BitTorrent found a new chief executive, Cohen dissed the process and some of the other candidates in his blog: "Just because you were approached about being BitTorrent's CEO doesn't necessarily mean that I'd ever heard of you. If I had ever heard of you, it doesn't necessarily mean that I thought you had the necessary experience .... Even if I did think you had the necessary experience, it doesn't mean I wouldn't have gotten fuming mad at your name being suggested for any of a number of other reasons, including in some cases widely known lack of competence and morals." Heidrick doesn't talk about its clients and declined to comment about its work for BitTorrent.

The executive BitTorrent hired is Doug Walker, who had led graphics software company Alias Technology in Toronto. He is circumspect when it comes to Cohen but does say: "You're always going to have an honest conversation with Bram. To me that's fair, even if you may not always like it."

So does Bram Cohen's creation have a future? Some wonder if BitTorrent has missed its moment. Gaming companies are using the software to more swiftly and cheaply distribute their wares. Hollywood studios? Not so much. The company's reputation for piracy may be part of the problem. But media companies also are finding ways to deliver entertainment themselves. All of which has left Cohen & Co. retrenching—in mid-August they laid off 20% of 60 employees—and struggling to find a way forward.

Still, Cohen's original brainstorm has carried him far. And even if his company falters, or his attention is diverted to solving a different problem, his software will be used by millions of people around the world. |BW|

BUSINESSWEEK.COM | To learn more about how BitTorrent's Bram Cohen manages with Asperger's, watch a video interview at www.businessweek.com/go/tv/autism

Business Exchange

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In Defense of Piracy

In an essay in *The Wall Street Journal,* Stanford Law School professor Lawrence Lessig argues that our copyright laws are confusing, inefficient, and sometimes nonsensical. Lessig, who is on the board of Creative Commons and author of the forthcoming book *Remix,* believes that the war on peer-to-peer file sharing is a failure. "After a decade of fighting, the law has neither slowed file sharing nor compensated artists," he writes. "We should sue not kids, but for peace."

To read Lessig's essay, go to: **http://bx.businessweek.com/online-video/reference**

WHAT'S NEXT

Miami Ice: Broker Zalewski says it will be years before the market thaws

JEFFERY SALTER/REDUX

REAL ESTATE

It's Low, Low Tide In Miami

Vulture investors are swooping in to feast on the leavings of the housing crash

By Roben Farzad

On the 79th Street Causeway that connects inner Miami to the city's beaches, a colony of giant turkey vultures sits ominously on a radio tower, staring at the downtown skyline. Migratory scavengers, they're drawn to tall buildings.

Across the bay, vulture investors, that other breed of migratory scavenger, are feasting. South Florida is in the throes of a truly hellish real estate bust. Home prices are down 24% in the past year, with many places changing hands for less than half their height-of-bubble values. The region has seen foreclosures on more than $14.2 billion worth of property this year—a record. Developers can't sell enough units to pay construction loans. Condo boards are trying to keep the stairwells of their half-empty buildings clear of vagrants. Landlords are renting out units at daily rates to makers of porn films.

The bleak tableau is exactly what

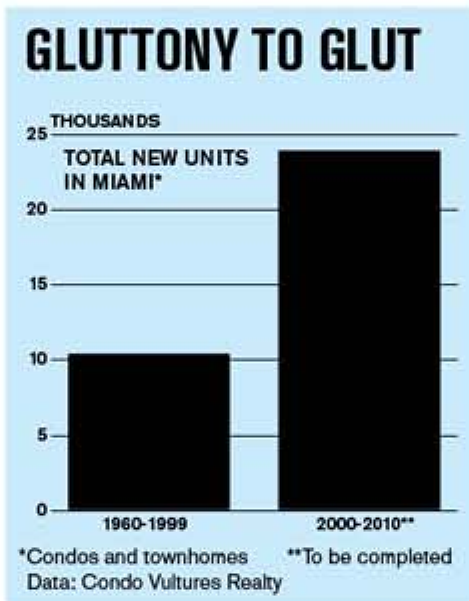
vulture investors have been waiting for. Having sat out the bubble, they're flocking to the Magic City to make lowball, often all-cash offers for numerous properties at once. Some members of this motley assortment of foreign professionals, U.S. money managers, and retired corporate executives learned how to prey by picking through the detritus of the U.S. savings and loan bust. Others earned their stripes in emerging-market financial crises. They differ in their tactics; what unites them is their absolute insistence on paying bottom dollar.

Consider the hard bargains being driven by Beverly Hills banker Joel Heffron. On a humid October morning he ventures into Miami's Brickell Avenue financial district to meet with Peter Zalewski, principal at Condo Vultures Realty, a Miami real estate brokerage and consulting firm catering to distressed-property investors. The two are looking for real estate for Heffron's personal portfolio. They size up the luxe lobby of a waterfront high-rise that was the first building on mainland Miami to break $500 a square foot. Now it anchors what Zalewski has christened the Foreclosure District.

EASY PICKINGS

And yet the building is still too rich for Heffron's cold blood. "Look," he says, taking off his sunglasses. "The deal that I want to do—where my heart is at—is to steal apartments that I can rent for a few years and then sell. I have the cash. What I need is a nice building—not too nice, but not popcorn ceilings, either—with ownership problems or people not paying their maintenance."

The two move on to the neighboring tower. Zalewski notes that the seven-year-old waterfront building has banned realtors from using lockboxes, which hold keys for other agents to show properties and are usually placed on front doors, so as not to advertise that entire floors of condos are for sale. And yet, a flyer in the elevator reads: "Come to the board meeting in the Clubroom to see the status of our collections, foreclosures, and delinquencies."



On the 14th floor, a foreclosed two-bedroom with an expansive view of the bay is listed at $299,000, down from $700,000 just months ago. Heffron, 65, thinks the property could go for less than $250,000. The bank, after all, isn't pleased about paying a $680 monthly maintenance fee, which from the looks of the building's unkempt pool deck is sure to rise. In this financial crisis, says Heffron, sellers have no choice but to cut their asking price every 10 days or so until the property moves.

Not since a hurricane devastated Miami in 1926 has the city offered so much property at such steep discounts. "You're not going to see a new condo go up in this town for seven years, minimum," says Zalewski. "The common Joe can't get a mortgage, and a 40% downpayment is becoming the rule for anyone who can. But if you have the cash, you can feast like a king."

Especially foreign cash. Esteban, a doctor from Colombia who requested that his last name be withheld, has seen his buying power boosted by the strong Colombian peso, which he swapped for U.S. dollars this summer when it hit a decade high. On a recent Tuesday he inspects a new two-bedroom condo with a wraparound balcony overlooking the port of Miami, one of several purchases he wants to make. The unit's absentee owner paid $650,000 pre-construction, tried to sell it for $515,000, and is now asking $489,000. Esteban is confident he can close on a deal near $425,000 before Christmas, having just spied a foreclosure notice on a neighbor's door. "I don't care if they tell me to f--- off," says the Colombian. "They have to face the bank, not me."

A mile south, Frank Marrero, a snowbird from Hoboken, N.J., is three luxury bayfront condos into a campaign to buy 15 by 2010. "If you have cash down here and say you'll close in two weeks, you're golden," says the 31-year-old mortgage broker. Marrero is targeting the nonrefundable 20% cash deposits that buyers have put down on properties still in development. He offers to repay the buyers some portion of their deposit to entice them to back out. Then he plays hardball with the developers. So far he has pulled off this maneuver twice, he says. His goal is to buy places so cheaply that he can rent them out for enough to cover the entire monthly nut and still produce 8% cash flow on the investment—with the option of selling the units at a profit if the market comes back.

"Hey, other people—not me—got in at crazy prices," says Marrero. "Now the weak are trickling off, and I swoop down for the kill." |BW|

Business Exchange

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Buyers' Remorse

When rueful condo buyers want out, the billable hours soar. *The Miami Herald* has been covering the surge in South Florida attorneys marketing the new legal niche of "contract cancellation." In a prescient Mar. 22, 2007, article, the *Herald* reported that "buyers seeking to get out of contracts are pouncing on changes in developers' plans" to wiggle out of contracts. What started as a novel legal ploy is now commonplace.

To read the *Herald* story, go to **http://bx.businessweek.com/real-estate-speculators/reference/**

CHART BY LAUREL DAUNIS-ALLEN/BW

Most Harley buyers at this El Paso (Tex.) store use financing from HDFS

BRENDAN MOORE

Risky Loans: Harley Hits the Slick

Its finance arm pumped up sales with hog wild lending. That could harm its pristine credit rating

By Matthew Boyle

Not long ago, a national marketing campaign from motorcycle maker Harley-Davidson addressed the sputtering economy with a heavy dollop of devil-may-care attitude. The tag line: "Screw It. Let's Ride.

Harley seems to have applied the same logic to its loan portfolio. In a pattern eerily similar to the housing bust, the $5.7 billion Milwaukee company used its in-house finance unit to chase after subprime borrowers, making it easy for them to buy $20,000 hogs with no money down. The risky lending—which forced Harley to take a $6.3 million write-down amid rising default rates and decreasing interest among buyers for its securitized loans—could foreshadow problems in other industries. Companies from retailers to blue-chip manufacturers such as Caterpillar, Deere, and Boeing (page 56) used finance arms to pump up sales and maintain an additional profit stream.

Harley-Davidson Financial Services (HDFS) has for years aggressively pitched retail bike loans to subprime borrowers, who now hold nearly a third of them. Now there's concern that the problems at HDFS could jeopardize the parent company's pristine credit rating. (*BusinessWeek* went to press before the company reported third-quarter results on Oct. 16, in which analysts expected earnings per share to decline 26%.) While acknowledging the "difficult environment," Harley spokesman Bob Klein says the subprime portion of the HDFS loan portfolio has remained between 25% and 30% since 2004. "Overall, the portfolio is very high quality," he says.

HDFS offers loans both to retail customers and Harley dealers, who finance the bikes that sit in their showrooms. Dealers can also earn incentives in the form of lower interest rates if they push a certain percentage of customers' loans and motorcycle insurance to HDFS. "We'd be crazy not to use [HDFS]," says Mark Barnett, a high-volume Harley dealer in El Paso, Tex., who says 83% of the new bikes he sells are financed through the unit. While HDFS made 38% of all retail loans for Harleys five years ago, that proportion now exceeds half.

ROARING GROWTH FOR HDFS

With credit markets frozen, Chief Executive James Ziemer faces some tough decisions. RBC Capital Markets analyst Edward Aaron argues that investors "need to know how [Harley] will raise capital to fund this business." BMO Capital Markets analyst Edward Williams says Harley is more vulnerable to a downturn because it "aggressively went after a lower-quality borrower" to gain market share against other lenders.

Indeed, between 2003 and 2006, the percentage of HDFS borrowers paying 15% or more in interest—an indicator of credit risk—increased from 8% to 19%, according to company reports. HDFS' share of Harley's operating income also grew to more than $200 million, about 15% of the company total, up from 7% in 2000.

The first sign of danger came early last year, when RBC's Aaron warned investors that loan delinquency rates were rising faster than normal, to more than 4%. While Harley trimmed production in response to slowing sales, it continued to go after marginal borrowers with promotions like 2007's

29%

Percentage of motorcycle loans from Harley-Davidson Financial Services held by subprime borrowers*

*end of 2007
Data: Company reports

"Stick it to the Man" campaign, which offered zero money down and teaser interest rates as low as 2.9%.

As long as HDFS could package loans and sell them as securities to investors, the strategy worked. In the first quarter of 2008, though, HDFS was forced to retain $54 million in loans no investor would touch. Even fewer buyers stepped forward in the second quarter as loan delinquencies kept rising.

SALES DOWN, JOBS CUT

Harley's finance arm has taken some steps to tighten lending to subprime customers. And its beefed-up loan collection staff is making more calls on weekends and evenings to chase down deadbeats. Klein says credit "may be less accessible" to customers with low credit scores and that HDFS has reduced its no-money-down financing offers, reserving them for the most creditworthy customers.

Softening demand for discretionary items such as motorcycles has exacerbated the woes at Harley's credit arm. Harley's U.S. retail sales were down 8.7% in the second quarter, and the company axed 730 workers earlier this year, its deepest workforce cut since the 1980s. Robust international growth rates are expected to weaken as the economic crisis spreads abroad.

Harley told investors last quarter that it remains committed to lending "across a broad credit spectrum," but analysts wonder how much longer the commitment to risky borrowers will last. "On one hand, you don't want to lose too much market share," says a buy side analyst. "But on the other hand, quite simply, you don't want to keep up your sales by extending credit to people who might default on payments."

A bright spot for HDFS is the particularly strong resale market for used Harleys just now, according to recent data from the National Automobile Dealers Assn. That reduces the severity of loan losses if HDFS is forced to repossess motorcycles. "The good thing about Harleys is they don't decline wildly in value," says Barnett, the Texas dealer.

Unfortunately, that can't be said of Harley-Davidson stock. The shares have lost half their value over the past two years. | BW |

FINANCE

Not All Lenders Are Losers

The credit arms of such companies as Caterpillar and Boeing appear largely unscathed by the crisis

By Matthew Boyle

GE Capital, once the golden child in its parent's portfolio, has been a drag in recent weeks as investors battered General Electric stock on fears the financing arm was vulnerable. But what about similar units of other companies? Whether a finance division is a plus or a peril depends largely on how the company uses it.

Cat's credit arm finances purchases of its own heavy equipment

JACK SMITH/BLOOMBERG NEWS

Take Caterpillar's financing operation, which makes loans to buyers of its heavy machinery. Cat Financial accounted for just 15% of the company's total pretax profit of nearly $5 billion in 2007. By contrast, GE Capital's contribution to its parent is about three times that. While Cat's bad-debt write-offs increased to $39 million in the first six months of 2008, up from $27 million in the same period last year, experts say Cat is well positioned to weather the crisis. "These guys are [financing] stuff they make and could sell" in the used-equipment market, points out Morningstar senior analyst John Kearney. "And they're not just financing to your average guy in the street." As Caterpillar CEO James W. Owens likes to tell investors: "We know the customers, and we know the product."

Then there's cheap-chic retailer Target and its credit-card unit. Earnings from the company's $8.7 billion credit-card portfolio more than doubled from 2005 to 2007. But that income stream is turning sour as many cardholders neglect to pay their bills. The unit's charge-off rate—those debts deemed unrecoverable—has soared to almost 10% of the total portfolio, up from 5.66% about a year ago. One problem, notes Christopher Garman, publisher of *Leverage World*, which follows the debt markets, is that as "companies chased this profitability, they took on too much risk."

Those who didn't—or couldn't—pursue easy profits might find opportunities amid the credit freeze. Boeing Capital hasn't made a loan in more than two years because airlines could get cheaper rates at European banks. With banks hoarding cash, Goldman Sachs estimates that Boeing could lend as much as $3 billion next year to hard-pressed buyers. While Kostya Zolotusky, Boeing Capital's managing director, says the unit hasn't made any loans yet, he notes "it is possible that customers could turn to us now." | BW |

Sweating Through An IPO Drought

With capital scarce, even the most promising venture-backed companies are running low on cash

By Spencer E. Ante

Gajus V. Worthington has seen the effect of the financial meltdown on U.S. startups, and it's not pretty.

The chief executive of Silicon Valley's Fluidigm set out to take his chipmaker public just over a month ago. On the first day of the road show, Sept. 5, Worthington gave a standing-room-only presentation to blue-chip investors interested in buying Fluidigm stock. Three weeks later, after panic seized investors, he pulled the plug on the initial public offering. Worthington realized he couldn't proceed after money managers he met with in San Francisco told him they didn't know how long they'd have jobs. "You could smell the fear," he says.

HIGH-STAKES GAMBLE

Now Fluidigm is in an awkward position shared by many of the most promising startups in the country. It has built up substantial operations in hopes of capitalizing on future opportunities yet it's burning through cash at a time when it's nearly impossible to get more from public investors. The company had $32 million in cash as of the end of June, and it's using about $6 million to $7 million a quarter. Worthington could run out of money at the current burn rate by the end of 2009, but he says he won't cut back, at least for now. "Our primary focus is growing the business," he says.

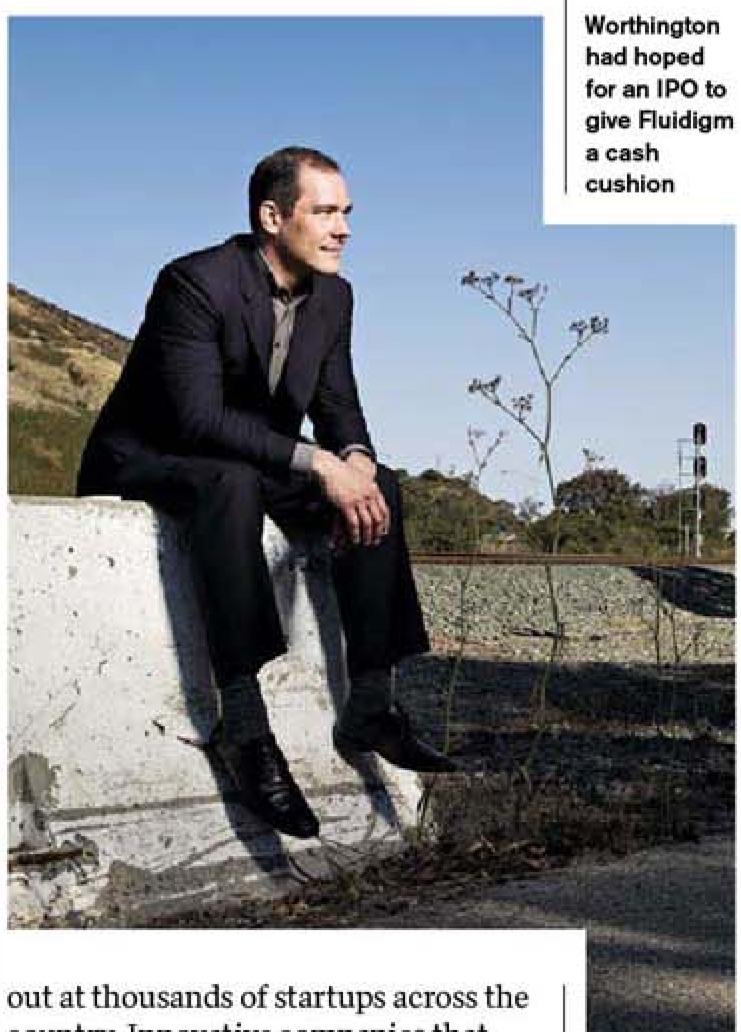
It's a high-stakes gamble that's being played out at thousands of startups across the country. Innovative companies that venture investors helped build in recent years now find they can't go public and it's much harder to sell out in an acquisition. Only one venture-backed company went public in the last two quarters, and the value of mergers and acquisitions fell 55%, to $10.6 billion, according to Dow Jones VentureSource.

1

The number of VC-backed companies that have gone public in the last two quarters

In recent weeks, venture firms have begun advising their portfolio companies to cut expenses and lay off staff. Sequoia Capital, the Silicon Valley firm that funded Apple and Google, gave its current crop of startups a bracing presentation. One slide showed the words "Death Spiral" and a skull-and-crossbones to signal the fate that awaited companies that didn't take quick action. "In the next six months you'll see a lot of companies go down," says Ted Wang, a lawyer at Silicon Valley's Fenwick & West.

Worthington doesn't think he can afford to slow down. Fluidigm's chips can manipulate fluids with thousands of tiny valves, making biological and genetic experiments faster and easier than in the past. Revenues nearly doubled in the first half, to $5.5 million, though Fluidigm lost $15.3 million.



Worthington had hoped for an IPO to give Fluidigm a cash cushion

ROBYN TWOMEY

Worthington had hoped to raise $80 million in the IPO to give him a cushion of cash. Fluidigm had priced the deal at 14 to 16 a share, but offers from investors quickly fell to single digits. At one point during the road show, Worthington checked into a hotel room and saw a newspaper lying at his feet. The headline read: "Worst financial crisis since the Depression with no end in sight."

The CEO laughs about the timing now. Despite the risks of running low on cash, he is determined to outrace his rivals. He's hiring marketing staff to help land more customers in biotech and academia.

Worthington draws strength from previous near-death experiences. After September 11, Fluidigm was running out of money, and it managed to scare up more capital. This time, Worthington figures that even if he can't go public, he could raise cash from Wall Street money managers or his company executives. "This is not the first time we've been through this kind of thing," he says. |BW|

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TJX: Dressed To Kill For the Downturn

Why T.J. Maxx may hold an advantage over other retailers as the recession deepens

By Jena McGregor

BW 50

T.J. Maxx has distinguished itself in past downturns as a place for high-fashion brands to unload extra inventory that other retailers can't sell. Recently brands ranging from Valentino to Calvin Klein have shown up in its stores.

But in the current credit-strained environment, there's another reason the off-price retailer and its parent TJX could stand to benefit: liquidity. TJX pays its vendors promptly and doesn't try to negotiate for additional deals if items don't sell, as department stores often do. Industry observers say that while those retailers can take 60 to 90 days or more to settle up, TJX typically pays within 30. These days, that's a critical selling point both to vendors, who are more concerned about finding funds to buy raw materials and pay expenses, and to the financers who act as middlemen in many of the deals. It could give TJX—which also owns discounters Marshalls and HomeGoods—an added advantage in getting a wider selection of items. As lending terms tighten up, says Burt P. Flickinger III, a retail consultant with Strategic Resource Group, TJX is like "a cash machine for the big fashion brands."

While TJX is reluctant to provide details about the terms it strikes with the 10,000-plus vendors on its roster, spokesperson Sherry Lang does say "we are religious" about paying promptly. The retailer can afford it. The Framingham (Mass.) company is seeing relatively healthy demand, having reported a mere 1% drop in September sales at stores open at least a year. That performance was poorer than expected, but still far ahead of such retailers as Gap, Chico's FAS, and Abercrombie & Fitch, which all turned in double-digit September sales declines.

Apparel makers, particularly smaller and midsize brands, are being hit on two sides. They frequently rely on a form of financing known as "factoring," in which brands sell their receivables to a third party, or "factor," for immediate cash in exchange for a fee. The factor then collects the payment from the retailer. With stores struggling, intermediaries are starting to demand better terms on those payments. New York-based Rosenthal & Rosenthal, which offers factoring to the apparel industry, says it's taking a closer look at retailers' creditworthiness, and says TJX's prompt payments make it an excellent company with which to work. Says veteran retail consultant Howard Davidowitz: "The factors are tougher than ever before."

Meanwhile, department stores are cutting back on how much they buy. Orders placed much earlier this year for the holiday season are suddenly being slashed, leaving fashion brands with excess inventory that's harder to unload in this environment. Because TJX buys later in the season, it's able to step in and stock up now.

The results are evident in the broader range of goods streaming into T.J. Maxx. A recent visit to the Oak Creek Village Shopping Center in Durham, N.C., revealed a T.J. Maxx outlet stuffed with everything from \$99 True Religion jeans (regularly \$160) to \$149 Bottega Veneta sweaters (ordinarily \$750). "The merchandise availability right now is just tremendous," says Patrick McKeever, an analyst who covers TJX for MKM Partners, an equity trading and research firm. Despite the inventory glut, TJX's Lang says the company has to be careful to choose the right garments, as department stores are cutting their prices right now, too.

Carol M. Meyrowitz, TJX's chief executive officer, is feeling confident. "Customer transactions were up across virtually all divisions," she told investors in the Oct. 9 sales announcement, calling the company's position going into the holidays "excellent." While others are eyeing what may be the worst holiday season in decades, Meyrowitz' cash-friendly formula might just make for a happy holiday. | BW |

PAYING UP

TJX Settles Accounts Fast

30	Days or less	TJX
60-90	Days or more	Department stores

Data: *BusinessWeek*, analysts' estimates

TJX, says one consultant, is like a "cash machine for the big fashion brands."

TIMOTHY FADEK/POLARIS


agility
60%
stability
40%
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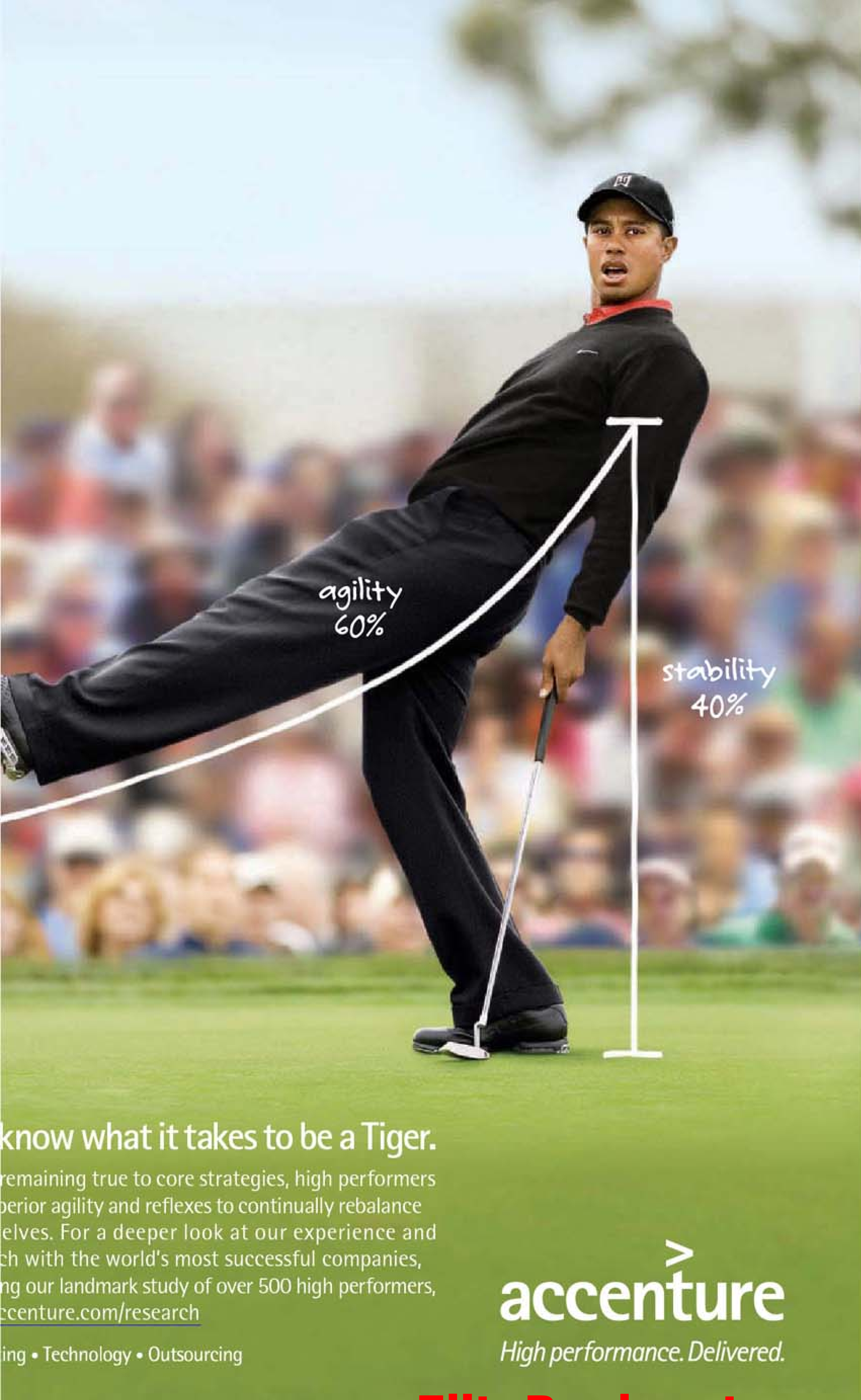
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IMMIGRATION

How Companies Abuse Work Visas

A new report confirms critics' charges against the H-1B program. Tighter oversight may be on its way

By Moira Herbst

For years critics have charged that the U.S. visa program for highly skilled workers is susceptible to abuse. Now the federal agency that issues the visas has confirmed some of those concerns.

The program for what are known as H-1B visas is designed to help U.S. companies bring workers with rare or specialized skills into the country. A Microsoft or IBM can use the visas to hire someone from abroad if they can't find an American citizen with equivalent skills. But in a recent study, U.S. Citizenship & Immigration Services (USCIS) found that 13% of the requests for H-1B visas were fraudulent and 7% contained technical violations. In one case, when a company requested a visa for a "business development analyst," USCIS found the person would be working in a laundromat, doing laundry and maintaining washing machines.

The study marks the first time the agency has documented systematic problems in the program. It's based on a sample of 246 H-1B petitions and does not name the companies involved.

Critics say the report underscores the problems with H-1B visas. They charge that companies use the visas so they can hire cheap workers from abroad instead of hiring Americans, pushing down pay and benefits in the U.S. "The report makes it clear that the H-1B program is rife with abuse and misuse," says Ron Hira, assistant professor of public policy at the Rochester Institute of Technology.

Hundreds of U.S. companies use the program to bring overseas workers into the country, and participants such as Microsoft and Google have long argued that the current limit of 65,000 visas a year should be increased. But the USCIS study makes it more likely that critics, such as Senators Dick Durbin (D-Ill.) and Charles Grassley (R-Iowa), will be able to win tighter oversight of the program before it is expanded. Presidential candidates Barack Obama and John McCain have both voiced support for expanding the program, with reforms.

The study found that 13% of H-1B visa requests were fraudulent and 7% contained technical violations

CLOSING LOOPHOLES

Bill Wright, a spokesman for USCIS, says the agency is already weighing adjustments based on the report's findings. It's developing a new risk-assessment program that, among other things, would closely examine requests from companies with 25 or fewer employees, since that category was found to have a higher rate of violations.

Technology companies also called for stepped-up oversight. "U.S. employers who play by the rules of the H-1B visa program are hurt when visas go to employers who don't," says Robert Hoffman, a vice-president at Oracle and co-chair of Compete America, a tech lobbying group.

The report identified a variety of violations by companies requesting work visas. Some H-1B workers didn't have the academic credentials or experience detailed on the applications. Others never worked at the location specified on their forms. Still other H-1B employees were paid less than the prevailing wage for their position and geographic location, another violation of the rules.

Durbin and Grassley say the USCIS report shows the visa program needs more oversight. Along with other reforms, they want the government to investigate program participants regularly, something it doesn't currently do. "Until we make a conscious effort to close the loopholes, we're going to see continued abuse where people coming to this country on H-1B visas are working at laundromats," Grassley said in a statement. |BW|

KOREN SHADMI

'This Would Be Bigger Than NAFTA'

Quebec is easing commerce and labor barriers with France, which may lead to a broader Canada-EU deal

By Pete Engardio

MONTREAL
It's easy to see how the penthouse offices of Fraser Milner Casgrain, one of Montreal's top law firms, can inspire envy. The view is superb: Blazing red foliage is starting to cover Mont-Royal, and the St. Lawrence River snakes through the city for miles into the distance. Inside, modern art lines rosewood-paneled walls.

Yet to Michel A. Brunet, the firm's CEO, his posh offices at times feel like a gilded cage. "I live in a world of restricted mobility," Brunet sighs. Quebec is the only Canadian province with a legal system based on old French civil codes. That means Brunet may not practice elsewhere in Canada, which like the U.S. uses a common-law system. And Quebec's onerous work rules mean even French corporate lawyers recruited by Brunet's firm have to go back to school before taking the Quebec bar exam. This can take five years.

On Oct. 17, French President Nicolas Sarkozy and Quebec Premier Jean Charest are set to sign an accord that could liberate Brunet as well as workers in hundreds of other professions who are hindered by the need for special credentials. The deal will allow for free labor mobility between Quebec and France for engineers, plumbers, pharmacists, nurses, and other professionals. Once they get visas, such workers from France will be quickly certified to work in Quebec, and vice versa.

What could be even more important, Canadian and European officials will begin preliminary talks in Montreal on a potentially much broader trade alliance between Canada and the EU. Besides freer labor movement, such an agreement could lower remaining barriers on trade in goods and include common health and safety standards. "This would be bigger than NAFTA," says Charest, referring to the North American Free Trade Agreement among Canada, the U.S., and Mexico.

Union boss Vaudreuil says Quebec's labor market must open up

SPYROS BOURBOULIS

The trade push is part of Charest's drive to make Quebec, long one of Canada's most closed labor markets, a magnet for global talent. He already has signed a similar labor agreement with neighboring Ontario and other provinces. A broader Canadian-EU pact could also speed a movement to simplify commerce in Canada's balkanized provinces, which have clashing rules on everything from margarine coloring (white in Quebec, yellow elsewhere) to the size of truck tires.

WORKER SHORTAGE

Why is free-trade sentiment gaining ground in Canada when it has become politically toxic in the U.S.? For one, Canadians crave new markets. Some 85% of exports go to the U.S., and a 40% leap in the value of the Canadian dollar against the greenback over five years has eroded competitiveness.

But the biggest driver behind a possible Canada-EU pact is the fear of labor shortages. Canada's labor pool is growing by just 123,000 a year, half the rate of 25 years ago. That number could drop to 42,000 by 2010, says business professor Linda Duxbury of Ottawa's Carleton University. Plunging birthrates have hit especially hard in Quebec, where aircraft maker Bombardier says it will need 3,500 more skilled workers by 2017.

Quebec's construction industry is also feeling the pinch. Masons, roofers, and carpenters are all in short supply. Until recently, Quebec's construction union, Centrale des Syndicats Démocratiques, kept tight control of jobs. And workers from most other provinces still must go back to school and pass a written exam, in French, if they want to work beyond six months. Now, with shortages intensifying, the union endorses freer labor mobility. "Twenty years ago, I don't think this would have been possible," says union president François Vaudreuil. "Now we have to open ourselves to the rest of the world." |BW|

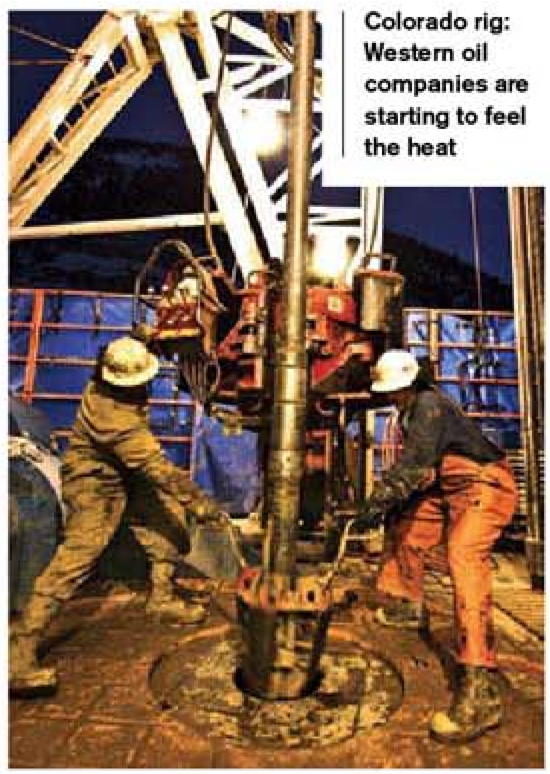
A Power Shift In the World of Oil

New data from Platts show producers from Russia and elsewhere are gaining on the top multinationals

By Steve LeVine

Big Oil is still king, but its dominance is under siege. Around the world, oil multinationals, such as ExxonMobil, Royal Dutch Shell, and BP, have never been so challenged. Even amid record profits from high oil prices, they're battling increased drilling costs, a serious shortage of skilled labor, and threats of higher taxes. And eclipsing all of these headaches is the muscle-flexing of such oil-rich countries as Russia, Venezuela, and Middle Eastern petro-states, which are increasingly shutting their doors to Big Oil to cultivate their own homegrown companies.

The multinationals remain industry leaders, but this year's rankings in Platts Top 250 Global Energy Companies, scheduled to be released on Oct. 20, highlight the declining power of U.S. and European heavyweights. (Platts, like *BusinessWeek*, is a unit of The McGraw-Hill Companies.) While Western oil companies occupy the top five spots, players from other regions are rapidly moving up the list.



Colorado rig: Western oil companies are starting to feel the heat

JT THOMAS

Russia, not represented among the top 10 companies on last year's list, now holds two slots. State-controlled Rosneft has moved up to No. 6, from No. 16 last year; while natural gas behemoth Gazprom is No. 10, up from No. 17. (Private Lukoil has advanced to No. 11.) The Russian companies have benefited from a combination of high oil prices and Russian Prime Minister Vladimir Putin's consolidation of the country's oil assets into a handful of players.

U.S. UTILITIES

Platts annually ranks the companies by assets, revenue, profit, and return on invested capital. Asian countries have added five more players to the top 100 over the past four years, while Eastern European countries have added the same number since 2005.

The steady shift of power is occurring beyond the realm of oil. The top half of the list also contains more U.S. electric utilities, which, after several tough years, are benefiting from higher prices, deregulation, and cost controls. Europe is also seeing a new generation of super-utilities, spurred by privatizations of state-run businesses and new rules that encourage cross-border mergers.

The latest list also reflects a trend to public listings in previously opaque parts of the world, such as the Middle East. Abu Dhabi National Electric (234) and Saudi Electric (170) are the first gulf outfits to be ranked. With more players seeking to augment state support with investor capital, the list is sure to grow. | BW |

PLATTS' 2008 TOP 10

COMPANY	ASSETS*	REVENUES*	PROFITS*	RETURN ON INVESTED CAPITAL	3-YEAR GROWTH RATE**
1. ExxonMobil (U.S.)	$242,082	$358,600	$40,610	30.5%	10.7%
2. Royal Dutch Shell (Britain)	269,470	355,782	31,331	22.6	10.3
3. Total (France)	176,463	198,872	19,158	21.8	3.7
4. Chevron (U.S.)	148,786	214,091	18,688	22.4	14.4
5. BP (Britain)	236,076	284,365	20,845	18.9	-0.1
6. Rosneft (Russia)	74,805	48,355	12,862	31.7	120.4
7. ENI (Italy)	157,843	126,825	14,551	18.5	14.3
8. StatoilHydro (Norway)	94,743	95,607	8,082	19.7	19.8
9. Petrochina (China)	152,685	113,901	19,864	17.8	29.0
10. Gazprom (Russia)	224,037	87,073	24,815	15.2	38.0

*Millions **Cumulative Data: S&P Compustat/Platts

BUSINESSWEEK.COM |
For the complete Platts ranking of the Top 250 Global Energy Companies, go to businessweek.com/interactive_reports/platts_2008

Medicare and the Credit Crisis Collide

For many seniors, autumn is when drug benefits run out. This year, that may mean months without meds

By Arlene Weintraub

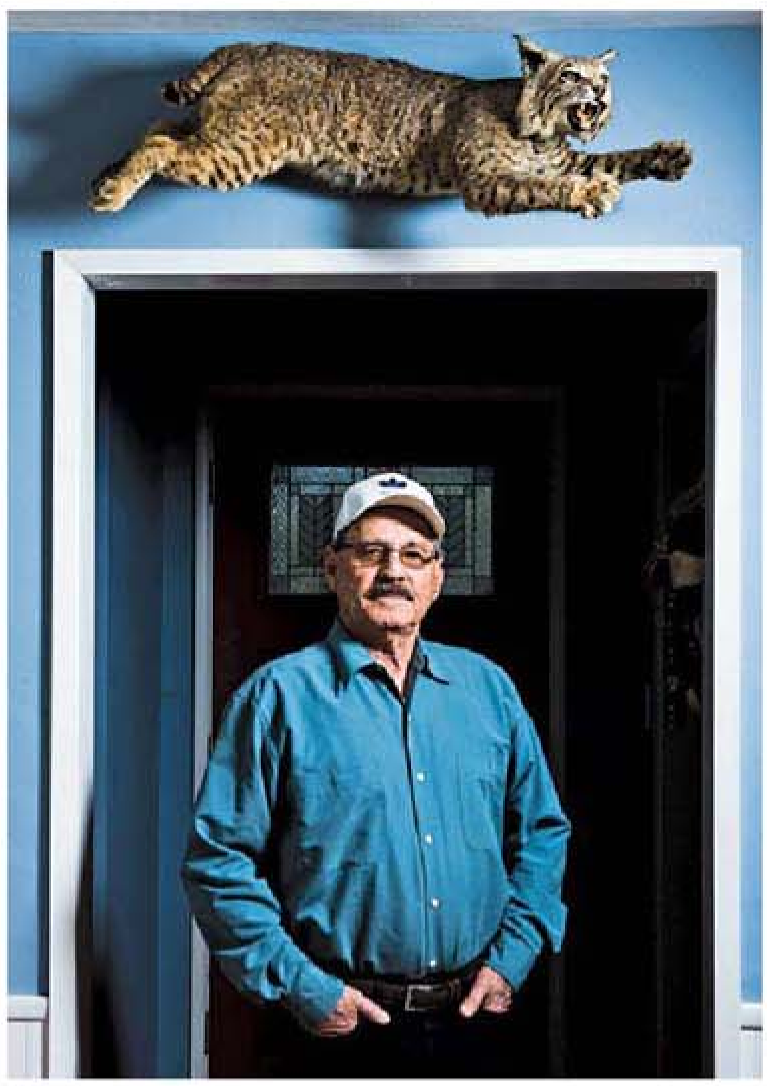
For many older Americans, fall is a bitter time of year associated with a deceptively sweet name: the "doughnut hole." Far from a sugary treat, it's a coverage gap in the Medicare Part D drug program.

When Part D was first implemented in 2004 to help elderly patients pay for their prescription drugs, the government imposed a yearly limit on how much it was willing to shell out. Seniors are covered right up until they hit the threshold, which is $2,510 in 2008. From that point until the end of the year, they pay fully out of pocket—unless their costs soar to the point where the senior qualifies for catastrophic coverage, which kicks in at $5,726.

The doughnut hole has always been a source of dread for the elderly. But now, with the financial crisis decimating 401(k)s and other retirement plans, many cash-strapped seniors are simply doing without some of their meds. In August a survey from the Henry J. Kaiser Family Foundation showed that in 2007, 26% of Part D beneficiaries—3.4 million people—landed in the doughnut hole. On average, their monthly out-of-pocket costs doubled, to $196. As a result, 15% of people with chronic illnesses stopped taking their drugs while they were in the coverage gap. "This raises concerns," says Tricia Neuman, vice-president at Kaiser Family Foundation in Menlo Park, Calif.

Kay is rationing his use of the inhaler prescribed for a chronic lung condition

Larry Kay of Yucaipa, Calif., is having so much trouble fighting his way out of the doughnut hole that he's thinking about coming out of retirement. A hunter and former quality-control inspector for a company that makes fences, the 69-year-old Kay



KEVIN SCANLON

hit the hole in May and is now paying $650 a month for drugs to treat his high cholesterol and a lung condition called chronic obstructive pulmonary disease, or COPD. He has stopped using his COPD inhaler in the morning, even though he's not supposed to skip doses. "If my doctor knew, he'd be very upset," he says.

Health policy experts believe the next Administration will be under pressure to address the doughnut hole, and both candidates have expressed some support for reforming the program. Senator Barack Obama backs the idea of letting the government negotiate drug prices for Part D. (It doesn't have the right to do so now.) Senator John McCain has said that higher-income beneficiaries should pay higher premiums for their Part D plans.

Right now, Wall Street's crisis and the $700 billion bailout plan are drawing attention away from health-care reform. But there is little doubt the next President will place drug benefits for seniors high on his agenda. "There is a growing recognition that the doughnut hole is impairing people's access to medications," says Dr. Carolyn Clancy, director of the Agency for Healthcare Research & Quality in Rockville, Md., a public service agency of the U.S. Health & Human Services Dept.

Meanwhile, the doughnut hole continues to exacerbate financial burdens on seniors. On Sept. 26, health-care advisory firm Avalere Health released a report predicting Part D beneficiaries who joined the 10 most popular Medicare plans would see their premiums rise by 30%. At places like California Health Advocates in Sacramento, which helps Medicare beneficiaries navigate the system, frustration is mounting, says spokeswoman Karen Fletcher. "Seniors go through the deductible, then they fall into the gap, then a new year comes around, and they have to start all over again," she says. |BW|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When the Punishment Fits the Stock Loss

Defendants in an AIG scandal face life behind bars, and the result may foreshadow subprime cases ahead

By Michael Orey

In coming weeks, five former insurance executives, including General Reinsurance ex-CEO Ronald Ferguson, are due to appear in federal court in Hartford. There, U.S. District Judge Christopher F. Droney will sentence them for their role in a sham transaction to boost the loss reserves of American International Group. When the deal was disclosed in 2005, prosecutors contend, it caused AIG's share price to drop 6% to 15%. Because of that, the defendants, who were convicted of fraud in February, could go to prison for life.

While the case involves events that seem far removed from the present financial crisis, it highlights an issue that's sure to be front and center if prosecutors seek retribution for the market losses of recent weeks. Under federal guidelines, the base-level sentence for someone convicted of securities fraud is zero to six months. But a variety of factors can increase time behind bars—including the size of shareholder losses, the number of victims, and whether a defendant is an officer or director at a public company. In reaction to the implosion of Enron, WorldCom, and other scandals that cost investors billions, lawmakers sharply raised the potential penalties in 2003. Now, instead of a few years in prison, fraud that results in stock losses exceeding $400 million could earn a defendant a life term.

Former Gen Re CEO Ferguson in February at federal court in Hartford

DOUGLAS HEALEY/BLOOMBERG NEWS

Given the size of losses related to the subprime meltdown, prosecutors may be able to threaten alleged culprits with lifetime incarceration. Reid H. Weingarten, a Washington attorney representing Elizabeth Monrad, the convicted former Gen Re CFO, argues that "this puts unhealthy leverage in prosecutors' hands to extract unfair plea deals." Going for the maximum sentence "may be popular in these chaotic times," he says, "but it usually has absolutely no relationship to the severity of the wrongdoing." Indeed judges in some recent securities-fraud cases have found guideline sentences draconian and have meted out far less time, especially when the crime did not imperil a giant company.

The size of current market losses "puts unhealthy leverage in prosecutors' hands to extract unfair plea deals"

In the case of AIG, the insurer's stock fell to 61.92 from 71.49 in the month following its disclosure of the Gen Re transaction and a subsequent probe by then New York Attorney General Eliot Spitzer. (Since then, AIG shares have dropped below 3 because of unrelated subprime losses that forced a massive government bailout.) Attorneys for the five defendants argue that a host of factors caused AIG's stock to swoon three years ago, including the forced departure of AIG chief Maurice "Hank" Greenberg. The defendants—including AIG's former head of reinsurance, Christian Milton—plan to appeal their convictions.

For sentencing, a lot rides on the complex and controversial discipline of determining market loss. Both sides retained financial experts to determine how much shareholder harm could be directly tied to the fraudulent inflation of AIG's loss reserves. The defendants say that amount was zero, which means under the guidelines they would face a year or two at most in prison. Prosecutors, seeking life, contend losses were as high as $1.4 billion. Such disparate conclusions are not uncommon, defense lawyers say. This points to the exercise as more art than science. "In the end, you're making a lot of sort of crude assumptions," says David Topol, a Washington attorney who monitors shareholder lawsuits for insurers. "When you get an enormous disparity, somebody's clearly wrong." | BW |

Finance guru Bodie (left), swaps ideas with Vanguard founder Bogle

PROTECTING YOUR NEST EGG IN VOLATILE TIMES

By Christopher Farrell

The savings American workers have diligently set aside for retirement is vaporizing. As of Oct. 7 retirement plans had lost as much as $2 trillion over 15 months, or some 20% of their value, according to the Congressional Budget Office. That has many workers wondering how they'll be able to retire and whether everything they thought they knew about investing has been turned on its head. Diversification across sectors and countries, for example, was supposed to protect investments, but few areas of the market have been spared. And what future returns can be expected from stocks and bonds? Have all of our rules of thumb gone out the window? We asked Jack Bogle, founder of fund giant Vanguard Group and a pioneer in the investment indexing business; and Zvi Bodie, a finance professor at Boston University School of Management, co-author of the leading finance textbook

ILLUSTRATION BY SEAN MCCABE; (BODIE) ROBERT SPENCER; (BOGLE) BILL CRAMER/WONDERFUL MACHINE

Investments and an expert on retirement security, to discuss issues facing savers and investors today. Christopher Farrell launched a discussion between the market veterans by asking if diversification remains a bedrock strategy. The conversation has been edited and condensed.

Jack Bogle: I am a believer in diversification. You buy index funds for stocks, and your bond portion should equal your age. This is how I invest, so I know how little it's hurt me to have a substantial position in U.S. bonds. I'm in half Treasuries, half corporates.

The most common diversification talked about is international. What's wrong is that as soon as people start really talking about it and believing in it, international stocks are overpriced. About 80% of money going into equity funds last year was going into international. If that isn't a warning sign! Here we are: The U.S. is one of the better-performing world markets. From the market peak in 2007, the S&P 500 is off 42.5%, international [measured by the MSCI EAFE Index of developed countries] is down 49.4%, and emerging markets [measured by the MSCI Emerging Markets Index] by 55.8%.

"Just two mutual funds—the risky assets and the safe asset—[will] generate the entire set of risk-and-reward trade-offs" ZVI BODIE

In recent years, international investing has had a higher correlation with the U.S. market than was traditional. If you invest internationally, you have to invest in foreign companies not as diversifiers but wealth producers. If you like international, get in gradually, maybe with 20% of your portfolio, half in developing markets and half in emerging markets. Europe looks a lot like us, so it's at least possible you might get a better return out of emerging markets. I don't invest internationally myself.

Zvi Bodie: I want to add something that strengthens your case. In markets like China, retail investors can invest only in the tiny fraction of equity investments traded on a stock exchange. So compared with the equity investments there that aren't traded on the exchange, those investments are way overpriced. A much better way to invest is to buy U.S. companies doing direct foreign investment in China.

I distinguish between diversification and hedging or insuring. When I use the term diversification, I use it in the sense that you have a bunch of risky assets, and instead of putting your money in one of them, you spread it across them by paying attention to whether those assets move in lockstep. Because if two risky assets are perfectly correlated, you're kidding yourself if you think you're diversifying.

And then there is insuring or hedging. That's when you've got a safe asset and to my mind that is Treasury Inflation-Protected Securities, or TIPS. One way to protect yourself is to combine a diversified portfolio of risky assets with the safe asset. We teach students that you only need two mutual funds—the risky assets and the safe asset—to generate the entire set of risk-and-reward trade-offs.

Bogle: Amen.

Bodie: And that could be provided at minimal cost. But then a lot of smart people working on Wall Street would be deprived of their high income. So they put all sorts of bells and whistles on these things, none of which has to do with improving the welfare of clients.

Bogle: If people would look at not just a percentage point in costs, but what 1% to 2% in lower returns costs you over a lifetime. Compound 8% and 6% over 50 years. Or use returns adjusted for possible inflation, so call it 5% and 3%. Take a dollar, and at 5% over 50 years it grows to $11.50. But at 3% it grows to just $4.40. Most people would not want to give that $7 difference to Wall Street, and they're right. Investors earned it, why give it all away? I've been working on this idea of low-cost indexing for a long time, and my record of failure in persuading active managers of its self-evident validity is just about 100%.

Bodie: But that's not true, Jack. Passive indexing is huge today.

Bogle: Vanguard's total assets are $1.2 trillion, and clearly indexing has been the driving force in our growth. But there are two things that are sad about that. One is that many index funds are just ripping off customers. They have 50 to 100 basis points of expenses, and it's ethically outrageous that people can sell these things.

Indexing is now about 14% of equity fund assets, and that's O.K. as far as it goes. I'd have thought it would get to 20% to 25%. It's proven to work and only works in low-cost mode. But the underlying tragedy is that indexing leveled off at around 9% of fund assets in 1999 or

Diversifying overseas hasn't paid off

-42.5%
S&P 500*

-49.4%
International markets**

-55.8%
Emerging markets†

Data: Bloomberg Financial Markets, 2007 peak to Oct. 10, 2008; *from Oct. 17, 2007; **MSCI EAFE from Oct. 29; †MSCI Emerging Markets from Oct. 3


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2000, and the growth to 14% is in exchange-traded funds [ETFs]. And those are index funds you can buy and sell in real time all day long. What kind of a nut would want to do that?

The other thing that really troubles me is commodities. People need to understand this infinitely important principle of investing, which is that stocks and bonds have an internal rate of return. For a bond, it's the interest rate compounded over the years. For stocks, it's today's dividend yield of 2.5% or so and implied 6% earnings growth. With commodities, you're betting solely on the expectation that you'll sell at a higher price than you bought. It will give you diversification, but I can't believe the rate of return on gold is going to be 7% to 8% a year, like the long-term return on stocks.

Christopher Farrell: On Wall Street the talk is about return, but both of you emphasize risk.

Bogle: You can control risk. You can't control return. That's up to the beneficence that stock and bond markets are generous enough to bestow on us. That's why we talk about diversification.

We can, however, look ahead and make reasonable predictions. In the bond market, we know with 90% probability that return in the next 10 years will be 4.5% to 5%. That's the historical number. If we have huge inflation and a Great Depression, and lots of bonds default—this is why I like Treasuries—then that's something else again. In stocks, we know the sources of stock returns. Dividend yield is almost 2.5%, and earnings growth from these levels ought to be 6% over the next decade. That's an 8.5% return.

Market volatility is to be ignored, up to a point. I said in my last book [*The Little Book of Common Sense Investing;* his new book is *Enough: True Measures of Money, Business and Life*] that it turns out the stock market is a giant distraction to the business of investing. Think about now, in this orgy of speculation. In 1929 there was 140% turnover in the U.S. market [meaning the entire market of stocks was bought and sold almost one and a half times]. When I came into the business in 1951 it was 25% to 30%

a year. Last year it was 280%. It will probably be 300% to 320% this year.

The volatility of the market doesn't really hurt the average retired investor because dividends keep coming in. But some of these dividends are gone. Companies that were paying them have gone out of business, almost entirely, actually, in the financial sector. So dividends are somewhat jeopardized, which I find broadly speaking one of the more challenging things. On the other hand, a lot is behind us.

Bodie: I'd supplement what we've been talking about by saying that everyone should think of his total capital as composed of a financial part and a human-capital part. If your human capital is safe, your nonhuman capital can be very tilted toward equities at a young age and tilted toward bonds at an older age. Let's take my son-in-law who works on Wall Street. His human capital is effectively a risky stock, since his industry is volatile. So I say to him over and over: "You want to be all in fixed income."

Bogle: Did you persuade him?

Bodie: Yes.

Bogle: I'm amazed, because if you're in that business you think trees grow to the sky.

Bodie: I was very forceful because he is in charge of my three-year-old granddaughter, who is the most precious thing in my life right now. |BW|

ETFs "are index funds you can buy and sell in real time all day long. What kind of nut would want to do that?" JACK BOGLE

Business Exchange

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Reassessing Risks

In the March/April *Financial Analysts Journal,* Vanguard founder Bogle predicted that "changes in the nature and structure of equity markets... are making shocking and unexpected market aberrations ever more probable." Such "black swan" events, he wrote, using a term popularized in Nassim Nicholas Taleb's book *The Black Swan: The Impact of the Highly Improbable*, are due in part to the financial economy swamping our productive economy.

To read the paper, go to **http://bx.businessweek.com/retirement-strategies/reference**

ILLUSTRATION BY SEAN MCCABE

FOUR WAYS TO SOFTEN THE TAX BLOW

By Amy Feldman

It's not something that makes good campaign politics. But given the crumbling economy and the federal government's budgetary needs, some Americans are likely to be hit with a tax increase regardless of who wins the Presidential election.

To be sure, there are vast differences in the tax plans of Barack Obama and John McCain. Obama's proposal calls for a bunch of middle-income tax cuts paired with an increase in the top marginal tax rates to 36% and 39.6% from the current top rate of 35%, to be paid by families with incomes over $250,000 and singles over $200,000. It would also increase the rate on those earners for long-term capital gains and qualified dividends to 20%, from 15%. McCain vows to extend George Bush's 2003 tax cuts on income and investments. (McCain recently said he would halve the cap-gains rate, to 7.5%, in 2009 and 2010.) Without new tax legislation, those rates are set to expire at the end of 2010. With a financial bailout to pay for and a potentially Democratic Congress, tax experts figure that rates on both income and capital gains will be in play over the next two years.

"The difference between the two [candidates] is not that Obama wants to collect more tax, but that he wants to collect it from different people," says Clint Stretch, director of tax policy at Deloitte in Washington. "One of the challenges is that both plans would collect less income tax [than is collected] today. In the Obama world, maybe fiscal discipline means some tax benefits he would give people don't come to pass. In the McCain world, maybe the extension of Bush tax cuts he proposes would not come into effect. It's really a question of how this gets bargained out with a Democratic Congress—if there is one—because if nothing happens then taxes go up."

It's unlikely that any tax plan will be pushed through quickly, so you have time to consider your options. Here are four ways you might be affected by higher taxes and some suggestions for thinking about the consequences.

With a bailout to pay for and a likely Democratic Congress, tax experts figure that rates on both income and capital gains will be in play

CAPITAL GAINS

Common wisdom says to sell your winners if you believe rates will go up. Yes, it's obvious. It's also not always the best strategy. That's because you're paying taxes early, and you'll need to recoup that outlay as well as transaction costs through higher gains on your investment. "Those two things can outweigh the tax savings," Stretch says. "If you have an investment with a low cost basis and low transaction costs, then it may make sense to sell. If you have a high basis or your gain is in the 10%-to-20% range, it probably does not make sense. For most people you are talking about a reasonably small amount of money, and there are cases in which taking the gain is detrimental."

Let's say you own shares of Stock A that is now valued at $10,000, and your cost basis is $7,000. If you sell now, at the 15% rate, you'll pay $450 in tax. If you wait, and the cap-gains rate goes

JACOB THOMAS

to 20%, you'd pay $600. Is that worth the potential $150 savings, especially after fees?

"The big question is, 'What are you going to put the money into? And will you earn enough more to recoup the taxes paid?'" says Robert Barbetti, an executive compensation specialist with J.P. Morgan Private Bank in New York. According to his figures, it would take two years invested in something that offered an additional two percentage points in return annually to recoup the tax paid in the example above. To make the right decision, you need to think about what you're going to buy once you sell, and whether it offers enough extra return to be worthwhile.

Think twice before you sell your winners to avoid a higher capital gains tax. Will gains from your new investment offset the hit?

COMPANY STOCK

With most 401(k) plans, if you've been laid off or are over 59½ and eligible for distributions, there's a little-known opportunity to take company stock out of the plan and pay tax just on its cost basis. Here's how it works. Say you have 100 shares of stock in Company X that trades at $50, and your basis is $10. You would take the stock out and pay $350 in tax, assuming you're in the 35% tax bracket.

The difference between the $50 value and the $10 basis, or $40, for tax purposes is called net unrealized appreciation, or NUA, and is taxed at long-term capital gains rates regardless of when you sell. Even without an increase in rates, that's a nice savings. At a 15% capital gains rate, you'd pay a total of $950, instead of $1,750 if you had to pay income taxes on the entire distribution. If the marginal income tax rate goes up, that benefit becomes more valuable. Barbetti says that with more people being laid off, especially on Wall Street, he's been seeing increased interest in this tax move.

DEFERRED COMPENSATION

If you're lucky enough to have a deferred compensation plan, you know that the big benefit is tax deferral, which allows money to compound tax-free until it's withdrawn. That's valuable if tax rates remain constant or decline. Even if tax rates went up as high as 50%, much higher than anything under consideration, deferring compensation would still make sense over the long haul. You might want to reconsider deferring compensation if you expect rates to rise at the time you want to take your money out.

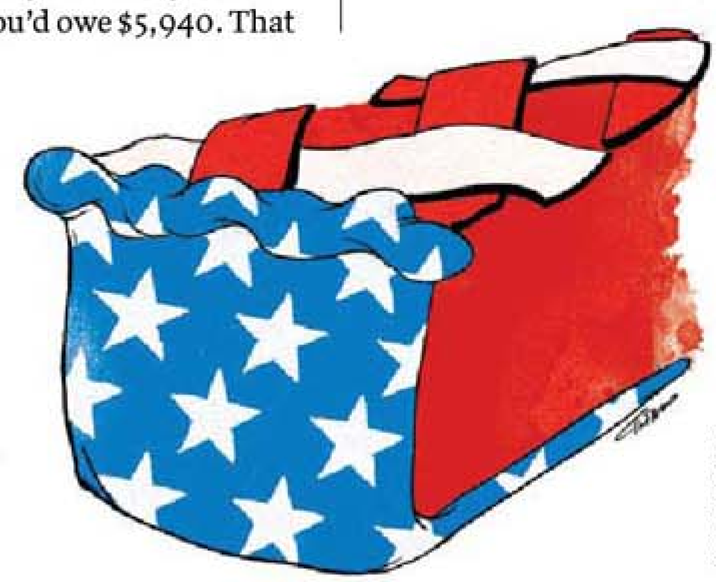
You'll need to think about this in advance. If you want to defer base salary and nonperformance-based bonuses earned in 2009, you will need to elect to do so by this Dec. 31. Once you choose to defer, you can't change your mind and take the money out of the plan sooner.

RESTRICTED STOCK

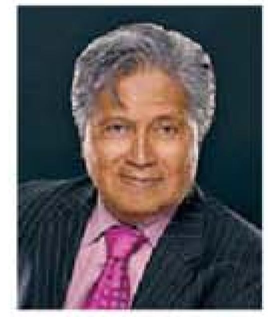
If you've been offered restricted stock, you should think about taking the 83(b) election. That election, which must be made within 30 days, allows you to pay the income tax up front and pay tax on future gains at the lower cap-gains rate. If you don't make the election, you pay tax when the stock vests, regardless of whether you sell it. If the stock goes up dramatically before it vests, you'll save yourself a hefty amount of cash by choosing the 83(b).

But if the stock remains flat (or worse, declines), you may have paid tax (or, worse, too much tax) years in advance for no reason. "You are triggering tax but not putting cash in your hand, so you need to look at the opportunity cost," says Deloitte's Stretch.

Say you're given $10,000 worth of restricted stock. If you're in the 35% bracket and make the 83(b) election, you'd pay $3,500 now. If the stock rises to $15,000 and you sell when you vest, you'd pay an additional $750 at today's 15% cap-gains rate, for a total of $4,250. (If the cap-gains rate goes to 20%, you'd pay $250 more.) If you didn't make the 83(b) election and paid income tax on the full $15,000, you'd owe $5,250. If you're in the highest marginal rate and it goes to 39.6% by the time your restricted stock vests, you'd owe $5,940. That potentially higher tax hit, plus the likelihood that stock you'd receive has been pummeled in the market rout, is why Barbetti recommends considering the 83(b) election now. "If you think your restricted stock will vest in a higher tax year," he says, "then maybe you bite the bullet and pay the tax this year." |BW|



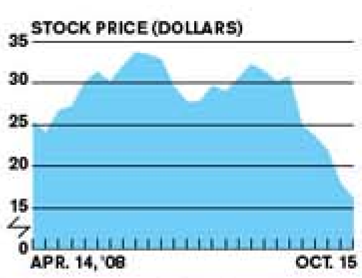
JACOB THOMAS



A HOT TICKET IN LOTTERIES

In recessionary times, lotteries are catching the fancy not only of people wanting to become instant millionaires but also of state governments eager to close their budget gaps. Scientific Games (SGMS) is reaping a bonanza from the mushrooming of lotteries—from Florida, Georgia, and Texas to China, Finland, Germany, and Italy. No wonder mogul Ron Perelman has accumulated a 28% stake in Scientific Games.

SCIENTIFIC GAMES TAKES A TUMBLE



Data: Bloomberg Financial Markets

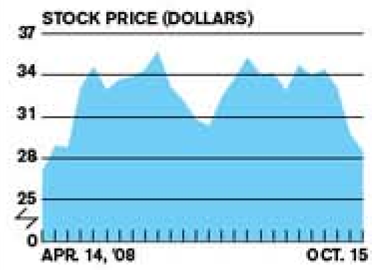
The company, which provides instant ticket and online lottery products and services "continues to win substantial [multiyear] contracts from both U.S. and international lottery authorities," says Steven Ralston of Zacks Investment Research, who rates the stock a buy. SG also provides computerized systems to the horse-racing industry and operates off-track betting facilities. Ralston forecasts SG will earn $1.14 a share in 2008 on revenues of $1.2 billion, and $1.58 in 2009 on $1.33 billion.

Like other stocks, SG, which hit 40 on Oct. 15, 2007, has tumbled: It's now at 16, near its 52-week low of 15. "We view that as a unique opportunity in view of several catalysts coming in the next three to six months," says Celeste Mellet Brown of Morgan Stanley, who rates SG, a client, overweight, with a target of 42. Among the catalysts: the launch of a new ticket-printing facility in China and approval of additional lottery games expected there before yearend.

BUSINESSWEEK.COM | Inside Wall Street is posted at businessweek.com/investor at 5 p.m. EST on Thursdays.

BRAD TRENT; CHARTS BY DAVID FOSTER

MARVEL A BIT LESS MARVELOUS



Data: Bloomberg Financial Markets

Marvel's Full Metal Jacket

With the box-office success of Marvel Entertainment's (MVL) *Iron Man* last summer, investors expect the stock of the company, which owns a library of 5,000 comic-book characters, will also show superhuman performance. Marvel (once controlled by Perelman) is licensing its characters to producers, toy makers, and comic publishers.

"Marvel's business is well insulated from the impact of a slowdown, and we think the stock [now at 28.40] can outperform the market by at least 15% over the next 12 months," says Doug Cruetz of investment firm Cowen. Marvel's second-quarter results, driven by strong licensing sales resulting from the popularity of its movies, beat Street estimates.

A new distribution deal with Paramount Pictures will boost Marvel, says Cruetz. He sees it earning $1.93 a share in 2008, $2.14 in 2009, and $2.25 in 2010, up from 2007's $1.70.

QUESTCOR IS GAINING GROUND

Data: Bloomberg Financial Markets

A Sales Boost For Questcor

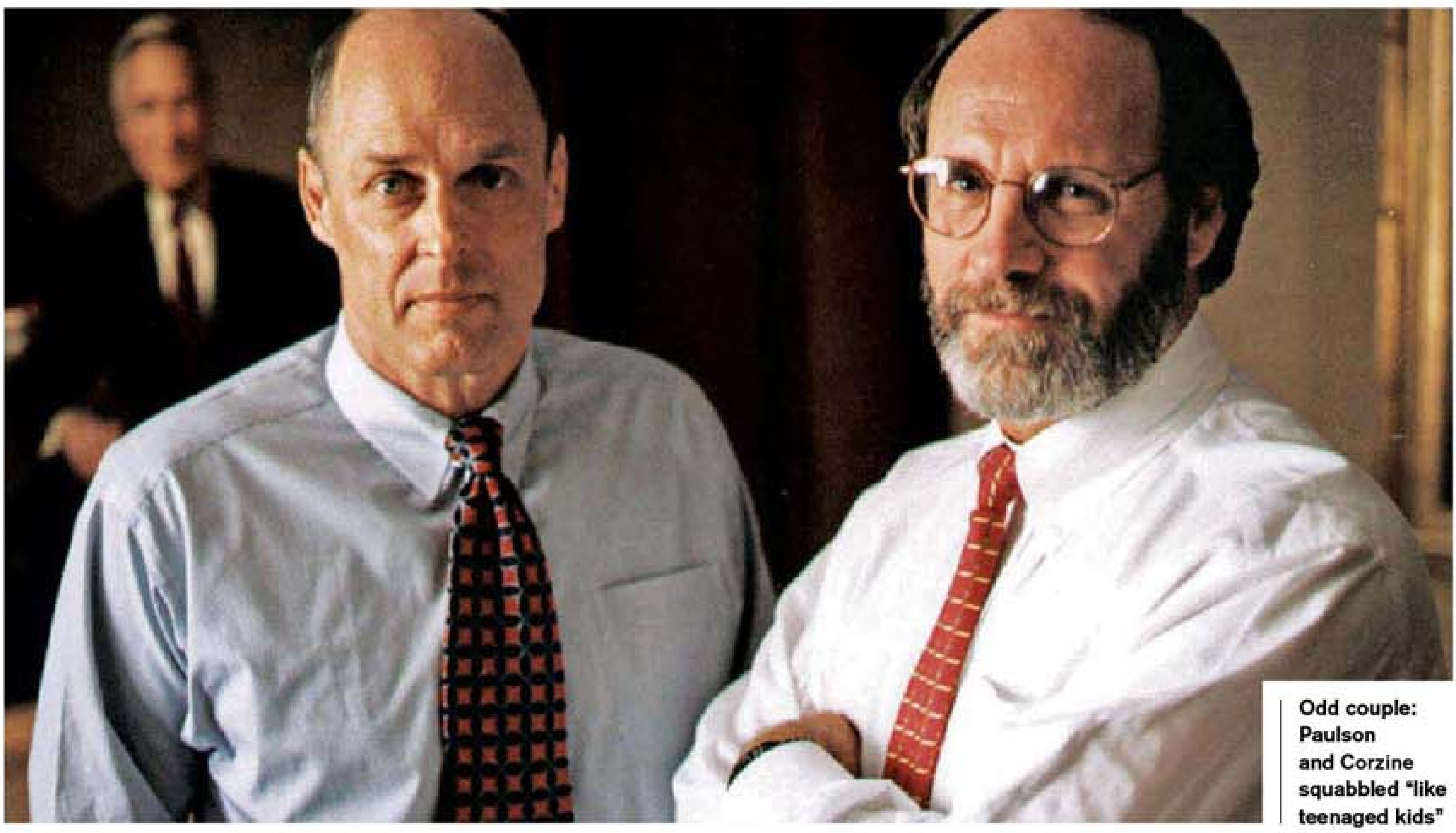
Tiny, little-known Questcor Pharmaceuticals (QCOR) is taking aim at two ailments: infantile spasms and multiple sclerosis (MS). Its recent sales spike comes from rising off-label use of its lead drug, Acthar, for baby spasms, a severe form of childhood epilepsy. Acthar, a purified peptide hormone, is approved by the Food & Drug Administration for over 50 indications. Some 3,000 U.S. babies suffer from spasms, and Questcor has a 40% share of that market, says Han Li of investment firm Stanford Group, who rates the stock a buy. He first recommended Questcor on Sept. 10, at 5.49 a share. By Oct. 15 it had risen to 6.71, so he hiked his target to 9 from 7.

Questcor has beefed up its sales force to boost its MS market share from 0.5% (115 patients) to 5.8% (1,492) by 2013. Han sees profits of 41¢ a share on sales of $90 million in 2008, and 50¢ on $100 million in 2009. | BW |

BOOKS | JOSEPH WEBER

Goldman Sachs' Long Climb to the Top

This history of the firm is rife with conflict and intrigue. It's also a vivid chronicle of Wall Street



Odd couple: Paulson and Corzine squabbled "like teenaged kids"

AP PHOTO

Time will tell whether Henry Paulson, architect of the Wall Street bailout, proves to be the savior of the U.S. financial system or just the redeemer of a lot of fellow fat cats. But the Treasury Secretary and former CEO of Goldman Sachs surely knows how to wield power. Take his role in ousting Jon Corzine, his onetime co-CEO at Goldman, after the odd couple—the methodical Paulson and the impulsive Corzine—squabbled "like teenaged kids," in the words of one colleague.

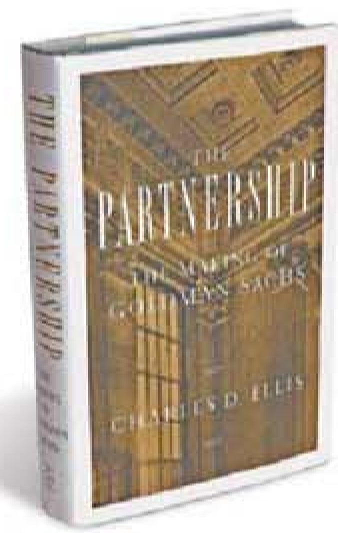
It seems the headstrong Corzine, now governor of New Jersey, acted too independently in 1998 to suit Paulson, an executive committee member at the then-privately held partnership. Corzine tied up too much capital in one risky deal and, flying solo, approached commercial banks such as Chase Manhattan about a merger. So, while Corzine, all unsuspecting, swooshed down the slopes in Telluride, Colo., on a family Christmas vacation, Paulson and three others hatched a scheme that forced Corzine out the door in a few months. The alleged plotters included John Thain, now chief of Merrill Lynch and the former head of the New York Stock Exchange, who was so close to Corzine that he was trustee-designate for his kids. Recalls a Goldman partner: "It was like living the history of imperial Rome."

That juicy tale is one of many in *The Partnership: The Making of Gold-*

man Sachs, Charles D. Ellis' 729-page paean to the famed firm. Ellis traces Goldman's evolution from a sole-proprietorship in 1869 to today, when it stands bloodied but still on its feet at the center of Wall Street.

Along the way the author provides a remarkable window into the growth of the Street. We move from genteel days, when poaching a rival's clients was something investment banks just didn't do, to more recent times, when insider-traders, dubious research analysts, and various fraudsters (there were surprisingly few at Goldman) became the subject of tawdry headlines. We watch firms move from basic stock-peddling to sophisticated derivatives-playing. And we see Goldman haltingly take its business global, although, amazingly, not in any big way until the mid-1980s. Lately, more than half of its profits in some years have come from outside of the Americas, and it is a major underwriting force in such frontiers as China.

The account is full of colorful detail. Sidney Weinberg, for instance, a seventh-grade dropout who chanced on a job as a janitor's aide at the firm in 1907, rose to steer Goldman through the Depression and lesser disasters until his death in 1969. "He ate, drove, wore, and used the products produced by [client] companies—cheese had to be Kraft, coffee had to be Maxwell House, cars were Fords, etc...." And like Paulson and a long string of Goldman honchos, Weinberg became a counselor to a President, in this case Franklin Roosevelt, for whom the Goldman executive worked during World War II. Weinberg had a son, John, who served in the U.S. Marine Corps in that war and later ran the firm until 1990.



***The Partnership: The Making of Goldman Sachs* by Charles D. Ellis; The Penguin Press; 729 pp.; $37.95**

At points, Ellis slips into inside baseball. His detailed accounts of financial dealings may interest only the most fervent market wonk. And he quotes too many executives at very great length, perhaps a result of the access he was afforded to more than 100 partners. At three-quarters the number of pages, the book might have been twice as good, especially if Ellis had dropped gushy superlatives that at times make the work read like an official history. How often must we hear how extraordinary Goldman staffers are? Can it be true that Goldman leaders "knew more about and cared more about their people" than those at any other firm, especially when market reversals pushed Goldman into hefty layoffs?

But those are quibbles. Ellis captures Goldman's mixed legacy: Its staffers have at times stood among the smartest on the Street, as when they largely sidestepped the subprime mortgage debacle. Earlier the firm narrowly missed hiring Michael Milken, the junk-bond felon, and Jack Grubman, the tainted dot-com securities analyst. But Goldman also stumbled: As the "principal financial enabler" to freebooting British publisher Robert Maxwell in 1991, Goldman was hit for $500 million in costs, most to settle with defrauded pension funds, Ellis says. And the collapse of Long-Term Capital Management, a Goldman banking client slammed by market reversals in 1998, cost the firm a bundle.

Pressed by the current financial crisis, Goldman is becoming a commercial bank, and so it may pull back on trading risks, jeopardizing its outsize returns. Clearly, times change: Paulson in 1999 vetoed an acquisition of J.P. Morgan that would have effected the same transformation, fearing that Goldman would lose its identity. Even with all the new regulators it will face, however, Goldman will continue to run its own show, probably providing material for still more books in the future. |BW|

BUSINESSWEEK.COM | For more on Goldman Sachs, watch a video interview with author Charles Ellis at www.businessweek.com/go/tv/ellis.

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Family Feud

In *Goldman Sachs: The Culture of Success* (Touchstone, 1999) ex-Goldman trader Lisa Endlich covers a lot in 326 pages. One section, echoed by Ellis, alludes to ill will between the intermarried Goldman and Sachs families after partner Henry Goldman backed the Kaiser during World War I. The bad blood lasted until at least 1967, says one source, when hardly any Goldmans were on speaking terms with any Sachses.

To read *BusinessWeek's* review of Endlich's book, go to: **http://bx.businessweek.com/goldman-sachs/reference/**

(BOTTOM) HULTON ARCHIVE/GETTY IMAGES

MEDIA CENTRIC | JON FINE

Is It Better to Be a Fox or a Mouse?

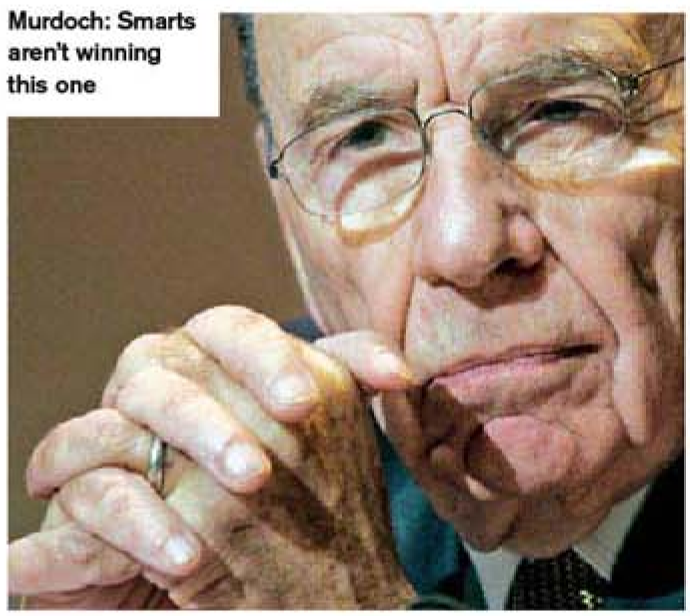
Disney is less dependent on ad revenues than News Corp., and today that's a saving grace

It hasn't been fashionable to be a big, groaning media conglomerate for a long time. So the remaining giants ardently woo investors, trying all manner of story and seduction to win a little bit of love, to be seen as not just like all the other guys. ¶ But in this era, it's no easy task for media megaliths to find a pretty come-on to convince Wall Street of their brilliance. Sumner Redstone finally gave up and in 2005 decided to slice his Viacom in half. Time Warner execs boast about a portfolio composed more or less entirely of top brands, but that pitch will go unheeded as long as it owns AOL, still the corporate equivalent of cement shoes.

The two best claims for company exceptionalism are those presented by News Corp. and Walt Disney. If I may grossly oversimplify, the stories go something like this: News Corp.'s Rupert Murdoch has employed his strategic brilliance to painstakingly assemble a machine that will outsmart all players on the global media chessboard. Disney deserves a premium stock valuation from its powerful brands and its unparalleled variety of ways to make money from them. (It's been selling this notion to investors lately, under the alliterative tag "the Disney Difference.") Both have been knocked around by the stock market in the past year. Disney's 27% drop over the twelve months ending Oct. 14 sounds grim, but such a showing outperforms its peers and market indexes. Just compare it with News Corp.'s 57% decline. Apparently, not all exceptions are created equal.

To mangle a metaphor, Murdoch's problem is that his papers have come home to roost. His newspaper division accounted for around 19% of News Corp.'s revenue in its last fiscal year, which ended June 30, making it the company's second-largest unit. Though there's more to Dow Jones than *The Wall Street Journal*, investors perceived that deal as a very expensive way to buy more newspaper assets, and time has not improved the aftertaste. (A company spokesman says the company is pleased with the *Journal*'s and Dow Jones' overall performance.) And, analysts say, its TV station holdings leave News Corp. further exposed to local ad trends, which have not been encouraging. And the digital pixie dust that the 2005 MySpace purchase sprinkled over the company lost some of its power in April, when the company admitted that the Fox Interactive Media unit (which houses MySpace) would miss its $1 billion revenue target. News Corp. hasn't provided one for fiscal 2009.

Murdoch: Smarts aren't winning this one



(FROM TOP) BRAD TRENT; MARK LENNIHAN/AP PHOTO

Murdoch is "still the smartest guy in the room," says one analyst. "But so what? People are still selling the [expletive] out of his stock." (Murdoch, who's sitting on $4.7 billion in cash, recently said he will only buy properties with two revenue sources—that is, nothing supported only by ads.)

The explanation of Disney's performance begins with one simple fact: Among its peers, the entertainment giant derives the smallest percentage of revenues from advertising. This is a good data point to have on your side when ad spending is tanking. Disney's stated selling point—that only it can take, say, *High School Musical* and extrapolate a gazillion revenue streams by leveraging everything from merchandising to movies to theme parks—has won traction with at least some investors. The mercurial reign of Michael Eisner is now in the rearview, and CEO Bob Iger wins plaudits for steadiness. The big question is what a recession—and a presumed travel slowdown—will do to Disney's theme parks business, which accounted for around a third of its revenue last quarter. (Company reps, citing a quiet period before reporting earnings, declined to make executives available for comment.)

While this slow media environment is likely mere rehearsal for what looms, Disney appears to be a better bet for stability. Ultimately, its trump cards are pretty prosaic: The company is less dependent on advertising, and it sold off a newspaper division in 1997. The media moguls perched in massive offices brooding over bold moves may not want to hear it, but in times like these, strategic brilliance doesn't drive their stocks. Avoiding anything radioactive does. |BW|

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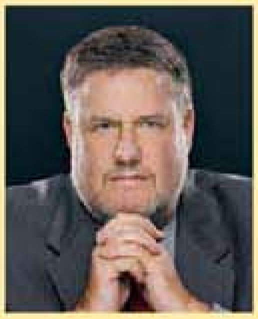
For Jon Fine's blog on media and advertising, go to businessweek.com/innovate/FineOnMedia.



Google's Shaky Smartphone Debut

Its Android software on T-Mobile's new G1 is intriguing, but everything needs work

In the software world, a "developers' release" is a preliminary, unfinished version of a program that lets engineers kick the tires and gauge its potential. Think of T-Mobile's new G1 phone as a kind of developers' release, a chance for ordinary customers to test Google's much trumpeted Android software for smartphones.

This iPhone wannabe is an intriguing but flawed effort—worth a look for early adopters but probably not what you want to carry as your everyday phone. The G1 will be available on Oct. 22 for $180 with a two-year contract; data plans start at $25 a month.

The design of the Wi-Fi-ready G1 handset from HTC makes assessing Android harder than it should be. With its awkward slide-out keyboard, the phone is difficult to type on. It also lacks features we are coming to regard as standard on contemporary smartphones. Unlike other big-display, touchscreen phones, the screen orientation does not change when you rotate the handset, and the display can only be used horizontally when the keyboard has been slid out. You can use a BlackBerry-like trackball instead of touch to navigate the screen, but I found this hard to use with precision. There's no stereo Bluetooth, and using a wired headset requires an adapter.

The G1 has a slide-out keyboard, but it's clunky

Then there's the network. As befits its Google heritage, Android is centered on Web browsing and needs a fast connection. T-Mobile's speedy new 3G network is available in only 21 cities and—based on my experience in Baltimore—3G coverage in those areas is spotty. I ended up doing nearly all of my testing of everything but voice on Wi-Fi.

Of course, there will be other and better Android phones next year, and 3G networks are improving. What about the software? The most promising thing about Android is the way Web services and search are integrated across applications. In many programs, anything you type into an open window is interpreted as a search request, tailored to whatever you are doing at that moment. For example, if you are in phone mode—the default state if no program is running—then typing initiates a search of contacts. A list of matches comes up as soon as you start to type and is refined as you add letters. Typing in the browser window opens a Google Web search; in Google Maps, it starts a location search; and in the Amazon.com MP3 store, you get a music search. If Android sees what looks like an address in a Web page or mail message, tapping it will bring up a Google map. All of this is clever and often useful. But typical of Android's many inconsistencies, when you start typing in any Gmail folder, nothing at all happens. If you want to search messages, you must hit the Menu button and choose search.

There's also a lot missing. You can sync contacts and appointments only through Gmail and Google Calendar. If you want to sync with Outlook or iCal on a computer, you first must get the data into the Google applications. There's no built-in video player other than a YouTube application, and the music player is miles short of iTunes.

Android's ultimate success will depend on third-party software efforts. Unlike the tightly controlled iPhone store, there are no limits on what Android programmers can do, which means we are likely to see lots of applications of decidedly mixed quality. For the moment, the Android Market offers only free programs. Since developers want to make money, the market lacks the polished applications, especially games, that make the iPhone so appealing—though I did have some retro fun with Namco's Pac-Man.

The iPhone has flaws, too, but Apple had all the important pieces in place from Day One. Android is a work in progress. I suspect it could be a formidable competitor in six months or a year, but it has a long way to go. |BW|

Android can be clever and often useful. Tap an address in a Web page, for example, and a Google Maps window appears

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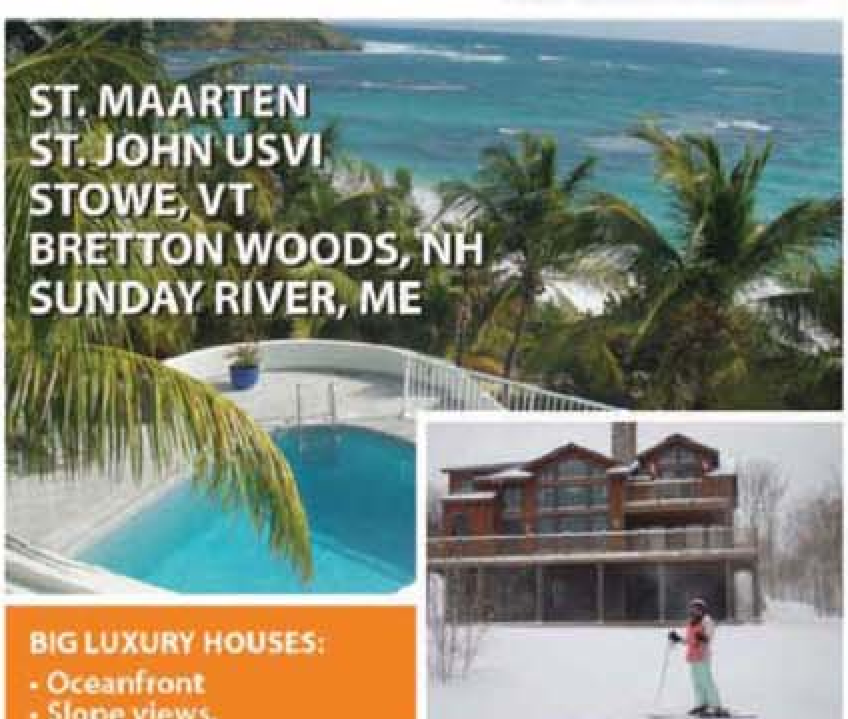

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FAKE CHIPS THAT PUT THE MILITARY AT RISK

"Dangerous Fakes" (In Depth, Oct. 13) offered readers concerned about the financial crisis something else to worry about: counterfeit parts in America's weapon systems. The article traced the path of fake military-grade microchips that make their way from China to unregulated U.S. brokers, who, in turn, supply the Pentagon and defense contractors. "These brokers should be charged with treason," wrote one reader, as a debate raged on our Web site about where to assign blame. Others argued that critical military components should be made exclusively in the U.S. *–Brian Grow*

The idea of securing materials from the lowest bidder to put in military equipment is just laughable. It's wrong to blame the Chinese. If U.S. military officials want to behave like dumb tourists buying sapphires in Bangkok, it's up to them!

Screen name: Tony157

Our lawmakers have to mandate that certain critical products be made in the U.S. But I guess they're too busy helping their Wall Street buddies.

Screen name: alskdjf

I say these brokers should be charged with treason. But this will be passed over by the public—busy worrying about what new, made-in-China thing to buy.

Screen name: Torino

There is no such thing as a "fake" or "counterfeit" chip. A more precise word would be "secondhand" or "refurbished."

Screen name: Fez

What do we have to do for our government to protect us from this rogue nation? First it was counterfeit luxury goods, then counterfeit foods and counterfeit drugs, and now counterfeit military parts.

Linda Galasso
HOLMDEL, N.J.

We see this all the time in the electronics industry: buying parts from China, then spending a ridiculous amount to have them tested. It brings the price up to what it would have been to buy from a reliable supplier.

Screen name: Crystal

In a free market, which the U.S. so fervently champions, we can't fault Chinese entrepreneurs who see the moneymaking opportunity in recovering reusable chips from junked equipment.

Albert Chu
RANDOLPH, N.J.

The price of being a leader in this important area is the potential for being identified with the problem rather than the solution.

Our decision, as a defense contractor highlighted in the article, to attack the problem of counterfeit parts in the aerospace and defense industry comes from our commitment to our servicemen and women. We have no tolerance for inferior parts or technologies. We will continue to be candid and aggressive in our efforts to help the industry ensure the integrity of its products.

Michael Heffron
President, Electronics & Intelligence, BAE Systems
NASHUA, N.H.

THE POWER 100
GIVE SOCCER'S BIGGEST MOGUL HIS DUE

Placing Manchester United owner Malcolm Glazer at No. 33 on "The Power 100" sports industry list (Special Report, Oct. 13) is a gross miscalculation on your voters' part. This British soccer franchise is the most visible sports club on the planet. That alone should confer a higher rating for Glazer. You can throw in his Tampa Bay Bucs ownership as an afterthought.

Jon Feldman
BEL AIR, MD.

THE MORTGAGE CRISIS
PAUL O'NEILL FINDS THE ROOT OF THE PROBLEM

Former Treasury Secretary Paul O'Neill's point was right on: You can't put people who have insufficient income, no wealth, and no consistent job history into mortgages ("Paul O'Neill: Blunt Talk About the Crisis," Facetime, Oct. 13). The tragedy is that he and the Bush Administration did not see eye to eye. We'll need straight shooters like him in the new Administration.

Bob Schieck
ANTIOCH, ILL.

CORRECTIONS & CLARIFICATIONS
The illustrations for "Pink-Slip Special" and "Profiles in Pilfering" (BTW, Oct. 13) should have been credited to James Gulliver Hancock.

MATT MAHURIN

COMPANY INDEX

This index gives the starting page for a story or feature with a significant reference to a company. Most subsidiaries are indexed under their own names.
Companies listed only in tables are not included.

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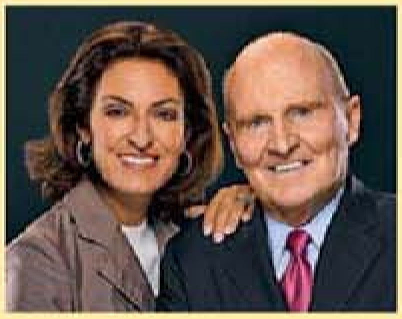
Trust in a Time of Turmoil

Why Washington is having to go to extremes to restore America's confidence



Is there any way to stabilize the current financial situation?

Roberta Lenhart
NORTH HOLLYWOOD, CALIF.

The government may have answered your question for us with its shock-and-awe $250 billion plan to deploy funding into large and small banks and loan guarantees to get interbank transactions moving again. It's too soon to tell if this program will unfreeze credit and reboot the financial system, but it's hard to imagine it won't go a long way toward putting things right again.

As we wait and watch, let's not forget why such a radical move was necessary. Washington was at the center of a perfect storm in terms of trust. President Bush, a lame duck in any regard, has an approval rating near 25%, and some of his recent speeches have made an art form of "mailing it in." Meanwhile, congressional leaders, with their even lower approval ratings, can't make a move without being suspected of ulterior motives, and some are, in fact, acting in a reckless, partisan manner. Two trust-damaging examples: House Speaker Nancy Pelosi's rant before the unsuccessful first vote on the $700 billion restructuring bill (now known as TARP) was essentially a stump speech, and Senate Majority Leader Harry Reid ruminating about an unnamed insurance company being close to failure sent that sector into a stock market tailspin. The only people generating any measure of confidence in the Capital are two appointees, Hank Paulson and Ben Bernanke. Yet even with their tireless efforts, their communication skills do little to dispel skepticism.

But we're not suggesting leaders can't build trust in mid-crisis. They can—by taking strong action, provided that action is taken quickly, openly, and straightforwardly. Together, speed, transparency, and simplicity form a "trust screen"—the closer any leadership move comes to meeting all three, the more trust it will create.

Trust can be rebuilt, even in the middle of a crisis, by leaders who make straightforward moves in a quick and transparent way

Indeed, several measures that were already being implemented in Washington—before Tuesday's announcement—passed this trust test. Take the increase in FDIC guaranteed funds from $100,000 to $250,000. It happened overnight, and people clearly understood its impact. The move was the essence of transparency and clarity.

But other parts of TARP weren't meeting the mark, in particular the plan to reduce foreclosure rates by buying up mortgages and the auctioning off of banks' toxic securities. Both programs practically shouted "Slow Rollout!" and appeared rife with complexity and potential for conflict. It was easy, for instance, to imagine homeowners demanding to know why the government was retooling their neighbors' mortgages and not their own.

Pelosi: Did her pre-bailout speech erode Americans' trust?

And so, with Washington's piecemeal approach not working, the credit markets remained paralyzed. And a howitzer response became necessary.

In all this, there's a vital lesson for businesspeople. When crisis strikes, it's awfully late to start thinking about how much trust you've stockpiled over the years. Trust is the very foundation of effective leadership; it's the grease of change. Leaders need to be building trust every single day. In every communication, they must rabidly avoid complexity and gobbledygook. There can be no pabulum and no mindless cheerleading. Just the plain, old truth, delivered the same way to every audience.

Business leaders can also build trust by connecting with their people. We're not talking about walking the hallways saying "hi." We're talking about forging relationships by hanging out where the work gets done, talking and listening, eye-to-eye. They should run frequent no-holds-barred town meetings. They should talk about who they are and what they feel, their motives and dreams. The more authentic a leader shows himself to be, the stronger the connections. Authenticity feeds trust.

We're hopeful that TARP and a new President and Congress will bring trust back to Washington. But for businesspeople, the reality that such an extreme response was needed should sound like bells tolling. Build trust while you can; build trust today. | BW |

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Jack and Suzy look forward to your questions. You can e-mail them and view their new Web site at welchway.com. For their PODCAST, go to businessweek.com/search/podcasting.htm.

(FROM TOP) BRAD TRENT; SCOTT J. FERRELL/CONGRESSIONAL QUARTERLY


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