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# State Street Heads-Up Finds Trouble Is Brewing

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Institutional money-management firm [State Street Corp.](#), relatively unscathed by the financial crunch, is facing potential losses in key areas, which threaten to pull it into the mire with so many others.

State Street on Tuesday is expected to report fourth-quarter earnings upwards of \$1 a share for 2008's fourth-quarter, up from the year-earlier period's 57 cents a share. But beneath that, trouble is brewing. On Friday night, just ahead of the long holiday weekend, the company in effect gave investors a heads-up.

While the firm booked healthy revenue growth in the first three quarters of 2008, its Securities and Exchange Commission filing Friday said some of its conservative, cash-like investments lost value and it is sitting on \$5.5 billion of unrealized after-tax losses on its investment portfolio. In addition, there are \$3.6 billion in unrealized losses on its other vehicles, known as conduits, which issue asset-backed commercial paper.

Further, in the fourth quarter, it took a \$450 million charge to cover declines in the value of investment pools known as "stable value" funds. Plus, the firm said some of its unregistered "cash collateral pools," which aim to maintain a \$1 net asset value, fell below this target because of declines in the value of the underlying assets, without specifying when that happened. The firm said "a substantial portion" of the declines in these assets came in the fourth quarter.

State Street said it has been redeeming its clients, primarily institutional, at \$1, partly because none of the securities in the pools "is currently in default or considered by the pools to be impaired," the filing said.

If it has to book further losses, State Street may end up under pressure to raise more capital to cover them, which is tough to do these days. And it also may be forced into putting the suffering conduits, now not listed on its balance sheet, onto its books. Gerard Cassidy, bank analyst with RBC Capital Markets, said the Friday filing likely was meant to prepare investors for "meaningful" and "adverse" issues with State Street's investment portfolio.

"We believe the assets in our conduits and investment portfolio to be of high quality, and we continue to believe that that they will mature at par," said State Street spokeswoman Hannah Grove on Monday. "Per the risk factors, we have had very few impairments to the assets."

State Street got a \$2 billion infusion from the Treasury's Troubled Assets Relief Program in October.

State Street has traditionally been known as a plain-vanilla trust bank that acts as custodian for big asset managers, who also outsource their back-office functions to the company. It also has a large investment-management arm, State Street Global Advisors, which manages both institutional money and mutual funds and exchange-traded funds.

In recent years, though, the company also was dabbling in more exotic fare, such as conduits - the entities that issue short-term paper and invest in longer-term assets such as mortgage-backed securities. These conduits have been hard-pressed since 2007, but problems have exacerbated in recent months. The firm's unrealized losses of \$3.6 billion on these conduits are up from \$2.1 billion in the third quarter.

State Street's Friday disclosures underscore how crippling problems in the unregulated banking industry are spreading to more mundane traditional banking as well. "The fact that they're caught up in this indicates everyone was playing this game" of getting into more off-balance sheet investments like conduits, says David Waddell, president and chief strategist at Waddell and Associates, a Memphis, Tenn., fee-only investment firm.

This isn't the first problem for State Street's investment funds amid the credit crunch. In 2007, some of its bond strategies, including an ultra-short bond mutual fund, fell sharply, shocking investors and causing a flurry of lawsuits against the firm. As of Dec. 31, 2008, State Street said it had paid \$417 million for settlement and related payments tied to these legal exposures.

-Diya Gullapalli contributed to this article.