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Sept. 3, 2010, 6:15 p.m. EDT

Stupid Investment of the Week

Commentary: Don't deposit your money into Citigroup shares

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- A lot of investors, looking for bargains and rebounds in the market, seem to be confusing "too big to fail" with "so big they're safe."

That seems to be why a number of people have recently asked my opinion of Citigroup Inc. (NYSE:C) , the banking giant that, at less than $4 per share, seems like a cheap way to buy a quality stock.

News Hub: Lakshman Achuthan on jobs & the economy

Kelly Evans talks to Lakshman Achuthan, Managing Director at Economic Cycle Research Institute, about today's employment report and his outlook for the U.S. economy.

In fact, Citigroup shares may be expensive at any price, making it the Stupid Investment of the Week.

Stupid Investment of the Week highlights concerns and conditions that make a security less than ideal for the average investor, and is written in the hope that showcasing trouble in one case will help consumers avoid danger elsewhere. While obviously not a purchase recommendation, the column is not intended to be an automatic sell signal.

Clearly, some investors can make a strong case for buying Citigroup (NYSE:C) . For starters, history says that Citi has made it through every rough patch it has ever encountered. Despite the massive problems experienced in 2008 and 2009, the company's annualized return on equity has averaged 15% over the last two decades.

Then there's that "too big to fail" label. While it's an open question as to whether the government will ever again provide bailouts for lenders that trade their way into trouble, politicians will look at how quickly Citi repaid the $20 billion of government TARP trust preferred as a sign that government rescues can actually work. By repaying the TARP funds and getting rid of bad assets, Citigroup is free from the restrictions facing companies that accept extraordinary government aid; that freedom should be a plus.

C **3.91**, 0.00, 0.00%

SPX **1,105**, +14.41, +1.32%

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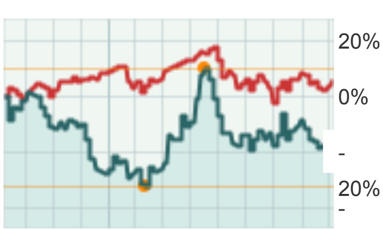

Then there is the valuation, at just under $4 per share for a stock that most analysts say has a fair value of between $6 and $6.50 per share. That would suggest that the stock is beaten down enough to be a bargain.

But as Warren Buffett once noted, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

And while the valuation proposition makes it unlikely that the stock will implode again, Citigroup is clearly no better than a "fair company" and might be a whole lot worse.

While the Citi slips

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While the Citi slips

"The big problem we have investing [in Citi] -- defined as purchasing the shares as an owner for at least three to five years -- is believing the company will never 'bet it all' again the way it did most recently with mortgages," said David Brady of Brady Investment Counsel in Chicago. "There have been some real banking reforms to give investors ease but, let's face it, risk incentives -- such as insured deposits -- are not only still there, but are even more attractive with higher limits."

Brady noted that Citigroup did not even mention structured investment vehicles in its 2006 annual report or 10-K, yet 18 months after printing those documents it was accepting federal bailout funds because those off-balance sheet investments had failed.

Look at the most recent documents on the company, and you'll find more than $7 billion in off-balance sheet debt, and more than $2 billion in underfunded pension liabilities. Plus there are massive asset write-offs, and while the TARP preferreds were paid off, there's no denying that Uncle Sam remains the company's biggest shareholder -- and potentially a motivated seller.

Moreover, no one is going to forget the bailout, least of all Congress, which is still itching to add to the regulatory burdens that companies like Citigroup are facing. Couple that with penny-pinching consumers and new rules that could cut into lenders' profits in the credit-card industry, and you have storm clouds that will linger for years.

Value trap

More importantly, however, is that while Citi looks like a cheap stock, some numbers suggest otherwise. David Trainer, president of New Constructs Inc., a Nashville- based research firm, said that at current levels, "Citi's stock price implies the company will grow its [net operating profits after tax] by over 15% per year for each of the next 25 years." That's a high hurdle for even the strongest businesses.

In most cases, analysts expect Citigroup to perform about average for the financial-services sector going forward, but note that the risks are far above average. Value Line, for example, gives Citi its lowest possible safety rank, a below-average score for financial strength, and bottom or near-bottom scores for price stability, price growth persistence and earnings predictability.

"The company has above-average appreciation potential over our projected three- to five-year period," said Gregg Brewer, Value Line's executive director of research. "But that assumes mostly positive outcomes all along the way. The other ranks and ratings highlight just how uncertain those positives could be."

Ultimately, perhaps the biggest danger is that investors attracted to Citigroup now are buying because they expect it to once again be the dominant financial superpower that it was before the credit crunch. That's just not in the offing.

Meanwhile, an investor hoping to capture the pop they perceive as being overdue in financial services can look to other stocks that pay a reasonable dividend and offer bright prospects for considerably less risk.

"Citigroup is the General Motors of the financial sector," said Jack Ablin, chief investment officer for Harris Private Bank in Chicago. "They seem to step in everything. They may be 'too big to fail,' but I think they may be too big to matter, too."