Is It Different This Time?

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During extraordinary market conditions of all kinds – good *and* bad – it is usual to hear people say, "It's different this time." Of course, every market environment is different from every other market environment, but what these people are saying is that market conditions today are so exceptional, so completely unprecedented, that investors will need to reassess everything they thought they knew about the investment process – or face serious consequences.

We heard this during difficult environments like the Great Depression, 1974, 1987, 2002, and we're hearing it again today. But it wasn't different on any of those occasions: investors who kept their wits about them and continued to follow traditional, thoughtful investment strategies were well-rewarded in every case.[1]

We heard the same refrain during very strong markets: the roaring Bull Market of the late 1920s, the Nifty Fifty Era of the late 1960s, the Tech Bubble of the late 1990s, and the recent liquidity bubble. In each case, true believers insisted, "It's different this time." In each case, the true believers were wrong and it wasn't different any of those times – traditional valuations reasserted themselves with a vengeance and those who thought it really was different that time were wiped out.

But let's not make the mistake of believing that just because something hasn't happened before, it can't happen at all. In fact, just in the past 20 months many events have occurred in the capital markets that most market participants believed were statistically impossible. More important, very fundamental shifts in capital market metrics really do happen from time to time, and the failure to recognise that "it's different this time" can, indeed, have serious consequences.

Consider the year 1958. Up until that time the dividend yield on stocks had always been higher than the interest yield on bonds. This seemed altogether proper to sensible investors: stocks were unsecured claims and therefore risky, and unless they paid a higher yield[2] than bonds to compensate for this risk, no one would buy stocks. But in 1958, for the first time, dividend yields fell below bond yields. Some people claimed, "It's different this time," but many investors believed that the yield environment in 1958 was simply a temporary aberration. Soon enough, they insisted, the proper order of things would be restored and dividend yields would again be higher than bond yields.

But it didn't happen. For 50 long years dividend yields stayed stubbornly below bond yields, and investors who didn't alter their investment strategies from bond-centric to equity-centric got left behind in the dust. Then, in November of 2008, yield differentials reversed themselves again, and for the first time in half a century, dividend yields rose above bond yields.[3] Again, some people are claiming that, "It's different this time," while others believe that the current yield environment is driven by a panicky flight to quality and soon enough bond yields will rise back above dividend yields.

But will they? Maybe bond yields will stay below dividend yields until 2058. Who knows?

Our point is that current market conditions, while not as unprecedented as many people are claiming (we have four words for them: The Panic of 1873),[4] are certainly extraordinary. Instead of assuming confidently that our traditional approach to managing capital is the proper one, might it not behoove us at least to examine the issue?

Which is what we propose to do in this paper, focusing on capitalism itself and its future in the US and around the world. As everyone knows, capitalism isn't exactly in good repute in the US or elsewhere at the moment, and for good reasons: if capitalism can produce what Stark Investments has called "economic kablooie,"[5] perhaps we should be looking for a better model.

We recognise the difficulties associated with a discussion of free markets in the current, dire environment. Behavioural economists have, after all, created a vast literature describing the non-rational behaviours we are all prone to, and it would be foolish for us or anyone else to claim that we are somehow uninfluenced by the conditions around us.

But if neither we nor anyone else can reliably rise above the current despair and look accurately into the future, we can at least do the opposite: look into the past. We can identify similar or analogous periods in the past when economies and markets were mired in serious malaise and observe what happened subsequently. Let's take a look.

CAPITALISM REDUX? OR CAPITALISM RIP?

Policy Failures in Dealing with the Current Crisis

No one who spent much time observing the antics of the Fed and Treasury in the Bush Administration can have much confidence that their efforts will prove very effective at restoring sound economic conditions. And since many of the key players under the Bush administration (especially Geithner and Bernanke) are also key players in the Obama administration, what hope is there that the new team will do any better than the old team?

We are, in fact, reasonably sanguine about the outcome of the US government's crisis-control efforts, albeit for reasons that are somewhat different from the views we've heard from others.

Public conduct matters

In the first place, we think there is an important distinction to be made between the validity of the policy initiatives an administration undertakes and the *manner* with which the initiatives are introduced and carried out. The simple fact is that no one knows which policy initiatives will prove to be effective and which won't. But we actually know quite a lot about how central bankers and exchequers should *conduct* themselves in public during economic crises. The reason is that the Bank of England – organised way back in 1694[6] – has dealt with dozens of credit crises, recessions, depressions, and other dismal economic events over the past 300+ years. That's a long learning curve that we ignore at our peril.

The BOE was sometimes successful in dealing with financial crises and sometimes not, but the key takeaway from its long experience is that *a crucial issue is public confidence in central bank and government policy*. To illustrate this point, let's travel back in time to an economic crisis that has particular resonance for us – the Barings Crisis of 1890.

In the late 19th century Barings Bank was running a distant second to the venerable house of Rothschild, but Barings' leader, Baron Revelstoke (Edward Barings), had an idea. Rothschilds may have had a hammerlock on Blue Chip business in Europe, but it considered the New World too speculative to be of interest. Revelstoke had no such inhibitions and Barings plunged into South America with abandon.

For a time all went well and Barings found itself closing in on Rothschild as the leading banking house in Britain. But in 1890 Revelstoke over-extended himself. Barings had received from Argentina – then as now one of the world's worst-managed economies – a pledge to adopt and maintain a sound program of economic and monetary reform. Based on this promise, Barings agreed to underwrite a huge (for the times) project involving a sewage system and waterworks for Buenos Aires. Alas, Argentina reneged on its pledge, adopted populist monetary policies and – surprise, surprise – hyperinflation broke out. Trying to sell nominal bonds in a hyperinflationary environment was beyond the talents of even a Baron Revelstoke, and Barings found itself stuck with a large volume of unsaleable and probably worthless bonds.

As word spread of Barings' plight, worried investors began to withdraw their capital from the bank. In particular, the Tsar of Russia let it be known that he might demand the return of Russia's deposit at Barings – and if the Tsar had done so, Barings wouldn't have had the funds.

There was no particular sympathy for Barings – Revelstoke had ridden the tiger and was now about to be consumed by it – but the Bank of England quickly concluded that Barings was Too Big to Fail. The mere possibility that a bank like Barings might go under had sent London into a panic, and the crisis soon spread to the United States, where the stock market swooned on the rumours. Investors were withdrawing money from other British banks, and it seemed possible that many of them might fail, too. Even Nathan Rothschild, who had been appalled by the risks Barings had taken, was forced to admit that a catastrophe had overtaken the British financial world and that London's position atop that world was itself endangered.

Enter the Bank of England, which had dealt with many credit crises before – most prominently in 1697 (fears over a debased currency)[7], in 1720 (the South Sea Bubble), in 1826 (a banking and stock market crisis which nearly sent the young Disraeli to debtor's prison), in 1847 (the so-called Week of Terror, when major banks failed and the stock and bond markets disintegrated), and in 1866 (the Overland Gurney Crisis). The BOE arranged a meeting of the largest banks in England and announced that it would contribute to a rescue of Barings if the other banks would also contribute. After some hesitation, the banks agreed, Barings was bailed out, and the crisis was resolved.[8]

Did the BOE know that the other British banks would support a bailout of Barings? Hardly. Nathan Rothschild, the banker who mattered most, went into the meeting determined to see Barings fail. Did the BOE know that even if Barings was rescued the crisis would end? Of course not – no one knew how the public and market players would react. In other words, the bailout of Barings was a sensible strategy, but hardly a sure thing. But what mattered was how the BOE conducted itself during the crisis. Specifically, it managed the crisis in accordance with four key principles, which ought to be inscribed above the portals of the Eccles Building[9] in Washington, DC. These principles are:

Act with confidence. The public, legislators and market participants need to be assured that competent help is on the way. Any sense of panic or incompetence on the part of a central bank will deepen and prolong a crisis.

Be consistent. Markets hate uncertainty, and policies should not be adopted until they have been thoroughly vetted.

Emphasise transparency. In the Barings Crisis the BOE let it be known what its policy would be and why. People could disagree with that policy, but at least they knew what was going on and why the BOE was doing what it was doing. When transparency is lacking, everyone worries and fears the worst. Better to adopt a policy a week late than to rush pell-mell into it "before the markets open in Asia."

Demand accountability. Barings Bank was rescued, but the cost to Barings, to the Barings family, and to Revelstoke personally was very high. The Barings partnership was dissolved and the bank was reorganised as a limited liability company; the financial losses to the Barings family were severe; Barings' position in the banking world plunged, never to recover.[10]

But let us now travel back to 2009. How have the Fed and Treasury measured up against the principles that have historically served free market economies well during credit crises? Let's look at each principle in turn:

Act with confidence. With the crisis at full boil, Bernanke and Paulson went into Full Panic Mode, shrilly insisting that the US Congress enact impossibly poorly conceived TARP legislation (based on a sketchy three-page memo) or the world would come to an end. Congress voted the bill down, and the crisis deepened. The Fed and Treasury, far from instilling confidence, infected everyone else with their own sense of panic.

Be consistent. Bear Stearns was saved, but Lehman was cut loose. IndyMac was closed but National City was saved (merged into PNC). TARP was designed to buy toxic assets; no, TARP was designed to inject capital into banks; no, TARP was designed to buy toxic assets. Markets, as we mentioned recently, hate uncertainty.

Emphasise transparency. From the very beginning, policymakers behaved as though all that mattered was that a small handful of key bankers and policymakers understand what was going on. Everyone else was kept in the dark about what they were thinking and doing. Small wonder that most people assumed the Fed and Treasury weren't talking because they were clueless.

Demand accountability. We need hardly even address this point, given the outrage with which Congress and the American people have reacted to the practice of doling out hundreds of billions of taxpayer dollars with no accountability at all.

In other words, the bumbling public conduct of our policymakers has convinced many people that they have no idea what they are doing, and this lack of public confidence has probably prolonged and deepened what was already a difficult-enough crisis.

The soundness of the government's policy initiatives

We wish Messrs. Bernanke, Paulson and Geithner had behaved better, but the public conduct of policymakers is just one side of the coin. The other side is policymaking itself, and here there is also an important lesson from the long history of central banker policymaking during economic crises, namely, *try not to do anything surpassingly stupid*.

This may sound easy, but in the context of very complex modern economies it's actually quite complicated. We know what a hash perfectly intelligent people made of the economic crises of the 1920s and 1930s.[11] Prisoners of prevailing economic wisdom, they starved the US and European economies of credit and capital at precisely the moment when those economies needed liquidity and stimulus. The result was not merely the deepest economic crisis of modern times, but also the creation of conditions in Germany – already reeling from punitive reparations payments – that led to the rise of Hitler and thence to World War II.

By comparison, US policymakers in 2007 – 2009 look positively like geniuses. They have acted quickly and significantly and in the right direction, i.e., toward stimulus and propping up credit markets and important financial players. Except for letting Lehman collapse, it's hard to say that our friends at Treasury and the Fed have done anything "surpassingly stupid."[12]

In the US the interbank lending market has been fixed, the commercial paper market is functioning again, no key financial institution has collapsed since the Lehman fiasco, a stimulus bill has been passed that is the largest in the world, a program to provide assistance to distressed mortgagors is in place, the TALF program is addressing the key issue of the shadow financial system, P-PIP is aimed at toxic assets, and so on. None of these initiatives is perfect and all were late in coming online, but their cumulative effect is likely to be profound.

And that is the point. We don't know which initiatives will work and which won't, but we know the direction the initiatives need to go (stimulating and stabilising) and that's what policymakers have done and will continue to do. President Obama and his team don't appear to have any better ideas than President Bush and his team (as we noted, the teams are alarmingly similar), but it is quite clear that the Obama Administration has the political will to do whatever is necessary, and that is what is needed.

A note about the Europeans

In Europe, central banks and governments were far too slow to recognise the seriousness of the crisis – the European Central Bank was still *raising* interest rates as late as the summer of 2008. Economic integration in Europe hasn't been followed by political integration – and may never be. Instead of one government making decisions for an economy roughly the size of the US, there are 27 governments making contradictory decisions. With Eastern Europe on the very edge of meltdown,[13] Western Europe is sticking its head into protectionist sand. And while everyone else on the planet is pleading for serious government stimulus programs, the Europeans bizarrely insist that the solution to the crisis is … regulatory reform. Hello? We're all in favour of regulatory reform, but regulatory reform is how you prevent the *next* crisis, not how you deal with this one.

So are the Europeans really surpassingly stupid? Of course not. They are simply reacting to a different economic history[14] than we are. When an American central banker falls asleep his worst nightmare is another great depression. That was the worst economic event to befall the United States, and Ben Bernanke isn't about to let it happen again on his watch. But when a European central banker falls asleep, his worst nightmare isn't another depression, it's hyperinflation. The Great Depression may have been a serious event for America, but it was a walk-in-the-park compared to German hyperinflation, the rise of Hitler, and World War II. Probably the world would be a better place if Americans had a healthier fear of hyperinflation and if the Europeans had a healthier fear of depression.[15]

Future Regulatory Activity

The received wisdom, at least Inside-the-Beltway and in the mainstream press, is that a major contributor to the Crisis of 2008 was the deregulatory binge of the Bush (and Clinton) administrations. If only the regulators and policymakers had not been rendered toothless (so the story line goes), most of the trouble would never have happened. The trouble with the received wisdom is that it is inconveniently inconsistent with the facts.

In point of fact, most of the financial institutions that got into trouble during the crisis were *heavily regulated* entities, not lightly regulated entities. For example, out-of-control institutions regulated by the FDIC and/or the Federal Reserve and/or state regulators – or, not to put too fine a point on it, by the Congress of the United States of America – included Citigroup, Wachovia, Washington Mutual, Fannie Mae, Freddie Mac, AIG, IndyMac, and so on. Out-of-control institutions regulated by the SEC and FINRA included Goldman Sachs, Merrill Lynch, Morgan Stanley and Madoff Securities. Meanwhile, the lightly-regulated financial firms, mainly hedge and private equity funds, either experienced few problems or only succumbed to problems created by the heavily-regulated firms.[16]

The trouble lay not specifically in a lack of existing regulations nor (albeit to a lesser extent) in a lack of enforcement of the existing regulations, but in the rather astonishing ignorance at the regulatory and policy level of what was going on among the institutions being regulated. In effect, our regulators were regulating an industry about which they knew very little.

It wasn't, for example, the collapse of the sub prime mortgage market that caused such chaos, but the fact that sub prime RMBS were stuffed into highly leveraged CMOs that were both sold and bought (and held) by financial institutions and institutional investors all over the world. Our regulators were dutifully monitoring the sub prime mortgage market, but they viewed it as far too small to be worrisome, even if defaults proved to be much higher than expected. They were, alas, imagining a financial industry that had disappeared a decade earlier, and hence they completely missed the many dangers lurking in securitisation and collateralisation.

Neither Hank Paulson (formerly a salesman for an investment banking house) nor Ben Bernanke (formerly an academic economist) knew much about how the financial industry actually worked in 2008. This became painfully clear as they zigged and zagged, trying this and that and the other thing to fix the financial crisis, much like anyone else would do who didn't have a clue. Did it make any sense at all to save Bear Stearns and allow Lehman to fail? What was the thinking behind injecting billions of dollars of taxpayer money into firms like Citi and Bank of America without removing the dolts who had caused the trouble in the first place? Whose idea was it to demand that Congress enact a $700 billion bailout package based on a three-page summary? Was the TARP program designed to buy toxic paper or to invest in financial institutions? Does it make sense to be so panicked about the next global depression that there is no time to worry about moral hazard or the nationalisation of an entire industry? What about the inflationary implications of such massive spending, or the consequences of leaving a staggering deficit as a legacy to our children?

What really needs to happen, then, is not more regulation or less regulation, but *smarter* regulation. We need to ensure that the staff at the Fed, at the New York Fed, and at Treasury (to say nothing of the SEC and FINRA) actually understand what is happening in the financial industry and what the consequences of those developments are.

But it is at least possible that Congress, possibly in its zeal to cover its own culpability for the mess we're in, will enact punitive legislation that will crimp the financial industry's ability to compete and innovate. It's also possible that the regulators, in their zeal to demonstrate that they aren't tools of the industry, will produce regulations that have the same effect.

But so far, so good. Regulations proposed by the Treasury Department seem mainly constructive. They include the authority to monitor and address broad risks across the economy, tougher capital requirements for large banks and the ability of regulators to take over large financial firms whose failure may have systematic consequences. Perhaps more important, the Obama administration has stiff-armed the biggest threat – the European call for global regulation that would supersede US regulation of its own financial system. There is much to be said for a common global approach to regulation of what is increasingly a global financial system. But that isn't what the Europeans (and Chinese) have in mind. What they have in mind is mind-deadening top-down regulation designed to do nothing more than recreate the US financial sector in the European mould, i.e., with governments largely in control of the allocation of capital.[17]

Serious policy mistakes in the past

In any event, how likely is policy and regulatory over-exuberance to be serious enough to cripple US capital markets for long enough to affect long-term, core investment practices? Pretty unlikely, we would say. Societies can make horrific policy decisions, to be sure, decisions which harm the competitive position of the nation for generations, and on the regulatory front this is what people fear who think, "it's different this time." History certainly provides examples of this sort of socio-economic self-abuse, but the reality is that they tend to occur only when both of two key conditions are met: first, the policy error is consistent with the zeitgeist of the national consciousness and, second, the usual feedback loops that allow societies to correct bad decisions are missing or corrupted.

To look at a particularly appropriate example, let's revisit the birth pains of the early stock exchanges in England and on the Continent. But before we do, let's also remind ourselves why stock exchanges are so important to market economies. As the Industrial Revolution was transforming Europe in the 16th century, the need for capital grew very rapidly. But in a pre-stock exchange world people with capital had to invest in extremely illiquid instruments, with no way to cash out for very long periods of time. As a result, the wealthy committed only very small portions of their wealth to the people and entities that needed capital, and the middle class – who had only small amounts of capital individually but very large amounts collectively – committed nothing at all. Enter the stock exchange.[18]

Suddenly, investors could commit their capital to very long-term enterprises while still enjoying short-term liquidity. Unfortunately, these early exchanges were hardly models of decorum and efficiency. They were unregulated and seriously rigged in favour of insiders. They were prone to huge booms and busts, and when the busts came it was mainly innocent investors who suffered. Needless to say, this caused widespread outrage, and when the South Sea Bubble hit England at about the same time that the Mississippi Company Scandal hit France (in 1720), public anger boiled over.

The reaction in England and France (and Germany) to these and other scandals is instructive. Up to this point, the English and French stock exchanges had evolved along largely parallel lines, but their paths would now diverge dramatically. The British Isles were the home of Adam Smith, after all, and the English were dyed-in-the-wool capitalists. Moreover, the power of the English monarch had been in decline since the days of the Magna Carta,[19] and by the early 18th century it was Parliament that wielded most of the power. Thus, in England, while public ire over the South Sea Bubble certainly led to calls for punishment of the wicked and for radical reform of the Exchange, not much actually happened. Parliaments are, as we know all too well, deliberative bodies, and Parliament deliberated for so long that public anger had begun to wane long before the legislators had reached any consensus. Ultimately, pallid reforms were enacted, but it is fair to say that the English parliament *under*-reacted to the South Sea scandal, introducing puny changes that made almost no difference to the way the Exchange operated.[20] Over time, Parliament gradually improved its supervision of the Exchange, making it more fair, more efficient, and more transparent, but this occurred over many years.

In France, matters proceeded much differently. The French had a long suspicion of capital, and the Mississippi Company Scandal merely confirmed French suspicions that capitalism was largely a criminal enterprise. Moreover, France lagged far behind England in the development of democracy – the French Revolution was still eight decades away – and so it fell to the royal house to respond to public demand for action. Which it did, by hounding the French stock exchanges almost out of existence. And if we imagine that it was just royal indifference to the exchanges that was operating here, let us remind ourselves that immediately after the French Revolution the revolutionary government was even more hostile to the exchanges than the kings had been, especially after the financial collapse of the *Directoire*. (At that point, the French even banned stockbrokers, so whatever little trading went on had to be done by investors themselves.) By 1827, when the new Palais Brongniart was completed as the Paris Bourse's permanent home, the French had come full circle and now favoured stock exchanges. But the damage was done. France was nearly a century behind England in arranging for the free flow of capital, and most trading had migrated to London.[21]

We know how this experiment in different policy responses turned out. Capital flowed into England in great quantities, feeding the extraordinary growth of the rapidly industrialising island. France, meanwhile, was starved for capital, and its growth lagged far behind that of England. Indeed, except for the brief years before Waterloo,[22] France's power would never again rival that of England. As late as 1910, nearly two centuries after the South Sea and Mississippi scandals, more than 90 per cent of all the equity capital bought and sold worldwide was traded on merely two stock exchanges: London and New York.

In short, there are two reasons to expect that American regulatory or legislative actions won't seriously harm the country's competitive position. The first is the American love affair with free markets – the zeitgeist that will always overcome temporary disappointments with capitalism's uglier side. The second is the democratic, open nature of the society itself – whatever bad decisions we make will be debated hotly until they are changed. As Winston Churchill was fond of pointing out, "The Americans can be counted on to do the right thing, but only after exhausting all the alternatives."

Government Control of Core Financial Institutions

Under the TARP program and under remarkably elastic interpretations of the Fed's powers, government money is being invested in financial institutions at an astonishing rate. In some firms (AIG, Bank of America, Citi) the US government is obviously now the dominant player and could take over management of the firms at any time. We need to keep in mind that even when the state remains a minority shareholder, the US government, with its many powers stretching far beyond stock ownership, will always be the 800-Pound Gorilla in the room.

But there are two compelling reasons to believe that our financial system isn't about to be nationalised.[23] The first is that nationalisation is an ugly word in America. Merely mentioning it as a policy option sends the markets reeling downward and the mentioner back-pedalling as fast as he can. When Senator Dodd brought the subject up, Geithner and Bernanke took pains to distance themselves from the Senator, who himself promptly backed down. Dodd was actually right – at least temporary nationalisation of the largest, weakest banks certainly should be considered as an option.[24] But Americans are allergic to the word and idea of nationalisation, and even if nationalisation of the entire banking sector turned out to be the best way out it would be impossible to get it done politically. As Alan Blinder recently wrote, "[N]ationalisation runs counter to deeply ingrained American traditions and attitudes."

The second reason not to worry about government control of the financial system is that there is really little *systematic* risk remaining in the financial sector, and hence no need for Americans to swallow too much of the bitter medicine of nationalisation. In the fall of 2008, after policymakers foolishly allowed Lehman Brothers to fail, everyone panicked, imagining that Lehman was just the first of the dominoes to fall. There was real danger of widespread run-on-the-banks that might have taken down the entire system, not just in the US but globally. But most governments around the world have made it clear that this isn't going to happen, and that governments – especially the US government – will stand behind the key institutions come hell-or-high-water. Once the panic disappeared, so did the systematic risk.

The remaining risk is limited to a few large but hopelessly enfeebled institutions, the ABCs of Ineptitude: AIG, BofA and Citi. The other large banks and the hundreds of smaller banks may not be lending, and they be conserving cash and generally battening down the hatches, but they aren't in any real danger of going under in large enough numbers to matter. Even if the economy remains weak for several years, we won't have a systematic banking problem, we will just have an ABC-of-Ineptitude problem.[25]

Enfeebled Firms

The collapse of AIG, Bear Stearns, Lehman Brothers, Merrill Lynch, and Wachovia, and the conversion of Goldman Sachs and Morgan Stanley into bank holding companies, has so altered the landscape of American financial capitalism that many people have concluded that an apocalyptic event has occurred whose consequences are simply unknowable.

But the wholesale collapse of uncompetitive firms has always been a hallmark of the financial industry, well illustrating the 'creative destruction' aspect of capitalism. In the 1980s and early 1990s, for example, 747 (that's not a misprint) savings and loans failed as the result of unsound real estate lending and poor regulatory practices. Similarly, following the end of fixed commission rates in 1975, hundreds of full service brokerage firms collapsed. While many of these were smaller, regional firms, others were then household names: "When E.F. Hutton speaks, people listen."[26] Even the global behemoths could no longer survive as free-standing firms, and thus Dean Witter disappeared into Morgan Stanley, Smith Barney disappeared into Citigroup, and Paine Webber disappeared into UBS. Ultimately, even Merrill Lynch would disappear into Bank of America, completing the annihilation of the industry.

Bear, Lehman, Goldman and Morgan Stanley were destroyed or transformed not because of some unknowable apocalypse, but because their business models were defective. Once leverage in financial firms with no deposit base exceeded the low teens (it would go as high as 30x or so),[27] the firms became hostage to lender confidence. Even the slightest decline in the value of pledged collateral could wipe out the capital base of the I-banks, causing the providers of leverage to withdraw it. Result: bankruptcy.

What sort of business model is it that can't tolerate even modest price declines? What sort of business model is it that can't survive for a week without the firm confidence of its lenders? Most banks with significant deposit bases, and virtually all other corporate enterprises of any kind, have survived massive price declines and massive liquidity crunches while barely skipping a beat.

Our point here is that it is a *good* thing for weak firms, poorly managed firms, or firms with fragile business models to perish, so that sounder firms can take their place. We agree, to be sure, that a vigorous investment banking sector is crucial to the health of capital markets not just in the US, but globally. But we don't see any reason why the I-bank sector has to look as it did in the recent, unlamented past. Freestanding, swashbuckling I-banks were a fixture of the US financial scene, but elsewhere in the world free market economies got along just fine without them. In the UK, France, Germany, Japan and elsewhere, investment-banking functions are handled by institutions that also engage in traditional banking. And that model also became quite vigorous here, once the Glass-Steagall Act began to moulder: at JP Morgan, Citigroup, Bank of America and other institutions, highly competitive[28] I-banking functions developed in competition with the Goldmans, Morgan Stanleys, Lehmans, and Bears.

Whatever the investment banking sector of the future looks like, it will continue to exist and will be more resilient than the old model, which proved itself to be an evolutionary dead end, like the dodo bird.

Distaste for American-Style Capitalism

When the Debacle of 2008 began in the US, schadenfreude[29] was thick in the air all around the globe: the American 'cowboy' version of capitalism was finally getting its comeuppance. Unfortunately for the rest of the globe, this happy moment was short-lived, as it soon became obvious that the European banks were even more deeply enmeshed in the crisis than the American banks (the Europeans being even more highly leveraged[30]).

Still, the schadenfreuders had it mainly right: virtually all the exotic financial instruments, derivative securities, and novel practices that fed into the debacle had been 'made in America'. While the Europeans (and, to a much lesser extent, the Asians) had enthusiastically adopted these practices, and sometimes (as with auction rate securities) even 'improved' on them,[31] it was the wildly inventive Americans who had brought the world the alphabet soup of CDOs, CDSs, CMOs, RMBS, CMBS, etc., etc. And it was also the wildly inventive Americans (and their regulatory cousins) who had from the outset seriously underestimated the risks inherent in the new securities.

In certain parts of the world, governments already so inclined will likely take advantage of this situation to migrate away from the American system of largely unfettered free markets and back towards the top-down, central-planning-centric model that prevailed in much of quasi-socialist Europe after World War II and which prevails today in Russia and China. But so what? We've seen this movie before, and we know how it ends: in much slower-growing economies in the top-down states and in even greater dominance by states that continue to rely on free-market principles, i.e., the US and emerging Asia. We hope the Europeans won't make the same mistakes they made in the 1950s, but they are, after all, grownups.

In particular, we think it would be especially disastrous if China leans even further toward state control of its economy than it does today. The very rapid economic growth exhibited by China over the past several decades may seem to suggest that a blend of state control and free markets offers a more robust alternative to the freewheeling, boom-and-bust (the schadenfreuders' words, not ours) American model. But we've seen this movie before, too, and for those of our readers who went out for popcorn at the wrong time, we'll briefly reprise it here.

Imagine that you have a vast country, rich in natural resources and large in population, but that your country is populated by uneducated peasants and ruled by a brutal, quasi-medieval government. What to do? Actually, it's quite simple in concept what you should do (although, alas, more complicated in the execution). First, you overthrow the bums currently in power and institute your own equally-brutal-but-more-modern government that will impose economic discipline on a top-down, state-controlled basis. Once you are in power, you know what you need to do to drag this bunch of hopeless peasants kicking-and-screaming into the 20th century: you need to build modern infrastructure. In other words, you instruct your peasants to build roads and railroads, to open and exploit mines, and to build and operate basic industrial factories.

In no time at all, geologically speaking, you will have transformed your country from an ignorant, medieval backwater into one of the most powerful industrialised nations of the world. We know how this works because in the movie we saw the Soviet Union did it in less than thirty years, roughly between 1917, when the bizarre Tsarist regime was hauled down, and 1945, when the USSR emerged from World War II as the second most powerful country in the world.

But that wasn't the end of the movie, only the end of the first half. The second half didn't go so well for the Soviets, because it is one thing to evolve rapidly from a simple agrarian society to a simple industrial society – it is another thing altogether to evolve from a simple industrial society to a maddeningly complex post-industrial society like those in the US and Europe. Top-down works, and works well, in Phase I (agrarian-to-industrial), if you aren't too delicate about human rights. But Top-Down doesn't work at all in Phase II (industrial to post-industrial). Post-industrial societies are so complicated that decisions simply have to be left to the invisible hand of the free market. Thus, China can't have it both ways. It can stick with its largely top-down model and remain a powerful (and dangerous) but simple industrial economy. Or it can aspire to the sort of post-industrial economy that can actually feed its people and offer them a good life, but it will have to give up control of that economy.

The Chinese know all this – they were watching the same movie we were watching. And they have done a good job of skating close enough to the free-market wind to enable their economy to grow rapidly and to begin to evolve away from its primitive industrial state, while not skating so close to the free-market wind that they lose control over the major part of the economy and over the government (thank you, Red Army). But now they are stuck. If disgust over (and fear of) capitalism causes them to turn away from free markets, their economy will also slip backward, with unknowable but horrific implications for social unrest. Our guess is that the Chinese will rant and rave about the wretchedness of capitalism,[32] but at the end of the day they will have no choice but to keep most of their toes dipped in the free market pond.[33]

We think, in other words, that both in Europe and in Asia people will get over their anger and resentment toward capitalism, for the simple reason that indulging it works against their own interests. At the end of the day, the idea that capitalism has been proven by recent events to be a failed idea is simply puerile. Recently the Wharton School and PBS's Nightly Business Report commissioned a survey to identify the 20 greatest inventions of the past thirty years, ideas like the personal computer, the Internet, and so on.[34] Can you guess how many of these critical inventions were 'made in America'? The answer is 19.5 of them.[35] Yes, America specifically, and free market economies in general, sometimes invent ideas that prove as destructive as they are useful (the splitting of the atom, for example), but if we destroy capitalism we destroy the main engine of human progress on the planet. People can be angry, but over the long term, people aren't idiots.

We go back to the behavioural issues with which we launched this section of our paper and suggest that the following are the steps to capital destruction, along with how we can avoid them:

1. During periods of extreme market sentiment, it is very important to remember that we can't know what *we think we know*. Our opinions may seem compelling to us, but that is because we can't escape from the extreme sentiments that surround us.
2. Since we can't be objective about our opinions under extreme conditions, we have to remember to discount them. Merely because most investors think eyeballs are as good as EBITDA (1998-99), or that the world is coming to an end (2008-09), doesn't mean those things are true. They are, in fact, likely to be very long shots.
3. Given that we have to discount the validity of our opinions, we therefore need to avoid taking the drastic investment actions that would be required if those opinions were true. We can boost our equity exposure if we really think growth stock prices will grow to the sky, and we can lighten up on equities if we really think the world is coming to an end. But if we do more than lean in one direction or the other, we are forgetting points (1) and (2), above.

In this paper we have tried to rise above the pea soup of fear and negativism that surrounds the outlook for capitalism by resorting mainly to historical examples. But how confident can we be that our opinions are right? Not very, we would say. And that, finally, is the point of this paper: when we are living through extreme conditions, it's important to avoid taking dramatic actions, to discount whatever opinions we hold, and, most of all, to remember that we can't know what we think we know. ●

** Please note that this paper is intended to provide interested persons with an insight on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.*

NOTES

1 Even in the darkest of those times – 1932 – investors who bought well diversified, equity-oriented portfolios achieved gains of nearly 280 per cent over the following four years. Of course, certain strategies fared badly during the Depression years. The great Benjamin Graham, author of *Security Analysis* (with David Dodd) and *The Intelligent Investor* and Warren Buffett's mentor, struggled during the Depression. His deep value style of investing caused him to buy many companies that looked cheap, but which were cheap for a very good reason, namely, that their future prospects were poor. Shades of 2008.

2 Until the 1920s it was considered impossible (or at least wildly speculative) to estimate the future earnings of corporations. As a result, the price/earnings ratio, which is at the core of today's securities analysis, was not used. Instead, investors used the price/dividend ratio.

3 For example, on 20 November 2008, the yield on 10-year Treasury bonds was 3.01 per cent, while the average dividend yield on the S&P 500 stocks was 3.45 per cent. In April of 2009, the yield on ten-year Treasuries was just under 3 per cent, while the dividend yield of the S&P 500 (including only stocks that paid dividends) was 3.3 per cent. 134 of the 500 stocks in the S&P don't pay dividends at all.

4 See *The Real Great Depression: The Depression of 1929 Is the Wrong Model for the Current Economic Crisis* by Scott Reynolds Nelson, 'The Chronicle of Higher Education', *The Chronicle Review*, Volume 55, Issue 8, Page B98 (17 October 2008). Dr. Nelson is the Leslie and Naomi Legum Professor of History at the College of William and Mary.

5 *Stark Investments Monthly Commentary*, November 2008, p. 6.

6 Interestingly, the impulse behind the organisation of the BOE was not an immediate economic crisis, but Parliament's need to raise funds for the War of the Grand Alliance, in which England and its allies successfully checked the expansionist plans of Louis XIV.

7 In 2006 Britain's trade deficit exceeded 4 per cent of GDP, finally surpassing the record set in 1697.

8 The Barings Crisis is described in much greater detail in B. Mark Smith, *A History of the Global Stock Market from Ancient Rome to Silicon Valley*, University of Chicago Press (2003), pp. 86-90.

9 The Marriner S. Eccles Federal Reserve Board Building on Constitution Avenue in Washington, DC is the headquarters of the Federal Reserve System. The prominence of the Chairman of the Federal Reserve Board (currently Ben Bernanke, formerly Alan Greenspan) has led many Americans mistakenly to assume that there exists a 'Federal Reserve Bank', the US counterpart to the Bank of England. America used to have such a bank. In fact, we've had two of them, the First Bank of the United States (1791 – 1811) and the Second Bank of the United States (1816 – 1836). But populist political views doomed both of those banks and, in deference to that opinion, the current Federal Reserve System consists of a series of twelve regional Federal Reserve Banks (the New York Fed being the most important) overseen by a Board of Governors whose Chairman is the visible embodiment of the system. But there is no national Federal Reserve Bank.

10 Quoted in Smith, op. cit., p.90.

11 An excellent recent discussion of the (catastrophic) policy decisions made in the 1920s and 1930s by the heads of the New York Federal Reserve Bank, the BOE, the Reichsbank, and the Banc de France can be found in Liaquat Ahamed's *Lords of Finance: The Bankers Who Broke the World* (Penguin Press, 2009).

12 The bailout of AIG's counterparties at 100 cents on the dollar was likely not so much 'stupid' as 'biased'.

13 As an aside, toxic assets in the US had nothing to do with the looming disaster in Eastern Europe – that was mainly the East Europeans' doing, aided and abetted by Western Europe's eagerness to lend to them. Over-borrowing, and especially over-borrowing in someone else's currency (the euro, e.g.), was the problem. When the East European currencies plummeted in value, East European corporations and even householders (mortgages were usually denominated in foreign currencies) couldn't repay.

14 While the fear of hyperinflation is the main driver of Europe's reluctance to 'over-stimulate', Europe in general and Germany in particular also face harsh demographics – long-term declining populations – that make it more problematic for Europe to burden future generations with heavy debt.

15 In this regard it may be useful to point out that stimulating an economy is politically easy – politicians love to spend money. But stopping inflation once it breaks out is politically very, very difficult. As Reagan and Volker demonstrated in the early 1980s, you only halt inflation by raising rates high enough to savage the economy, drive unemployment to astronomical levels, and risk the political careers of yourselves and your party if you fail (or don't succeed quickly). It doesn't surprise us that Congress and the President have shown the determination to spend their way out of the economic crisis, but it will surprise us greatly if they demonstrate the same determination when it comes to dealing with the consequences of the stimulation.

16 Hedge funds, recently all-the-rage, are now the villains-of-the-day, exceeded only by AIG's bonus babies. But just to put matters in perspective, here is the out-performance of the average hedge fund of funds versus the long equity markets over the last 1-year, 5-year, 10-year and 15-year periods, respectively (courtesy of Protégé Partners): +21 per cent, +22 per cent, +89 per cent, +74 per cent.

17 Actually, except for the zombie regulators in the EU headquarters in Brussels, most of the European calls for tough regulation of US financial firms were designed for their own domestic consumption, not because anyone actually thought it would happen.

18 We don't mean to imply that the concept of an exchange for the trading of investment instruments was invented in Europe. Stock exchanges had been around since at least the second century B.C. in Rome. But they were, in effect, re-invented and restructured to suit the needs of Europe's rapidly industrialising economies. Stocks were initially traded in Europe in open air locations such as fairs and courtyards – the courtyard outside the Hotel des Bourses in Bruges gave the 'bourse' its name – but the first permanent stock exchange in Europe was organised in Antwerp in 1531.

19 The charter of English liberties was granted by King John in 1215 under threat of civil war.

20 The reforms did operate as a precedent, establishing that the London Stock Exchange, theretofore a purely private body, was a quasi-public entity subject to ultimate supervision by the government.

21 The German reaction paralleled that of the French, except that when the German stock exchanges were shunted aside their function was usurped by the Grossbanken, whose successors still today control vast amounts of capital in Germany. Instead of acting as magnets for capital, available to all comers, the Grossbanken centralised and bureaucratised capital in Germany, eventually creating the complex cross-ownership ('diagonal' share holdings) that today link nominally independent firms and exclude the public.

22 Apropos of nothing, there is a very old story about the Duke of Wellington at Waterloo. Many of the Duke's troops were, well, riffraff: hundreds had been impressed into the army and others were released from gaol on condition that they fight with Wellington. The evening before the confrontation with Napoleon, an adjutant asked Wellington how he felt about his troops as the day of the battle loomed. Wellington gazed out across the field and remarked, "I don't know whether these troops will frighten the French, but they certainly scare the hell out of me!"

23 Alan S. Blinder, 'Nationalize? Hey, Not So Fast', *New York Times*, 8 March 2009, p. BU 5. Blinder is a former vice chairman of the Federal Reserve.

24 Of course there are huge downsides, but nationalisation might just cut to the heart of the problem: take over AIG, Citi and BofA, sell off the toxic assets at whatever price they will fetch, break the firms up into the smaller pieces they should have been broken up into long ago, and re-privatise them. The really important downside might be the impossible-to-resist temptation for the government to operate the banks for political reasons.

25 The government's quirky and highly politicised 'bank stress tests' were just finishing up as this paper went to press. Whatever the final outcome of the stress tests, and however much capital various banks will need to raise, we are confident that, except for AIG, BofA and Citi – all of which have, in the usual understanding of the word, already failed – no one will be in danger of collapse.

26 Who, you may be asking, is E. F. Hutton? Founded in 1904, E. F. Hutton was once the second largest US brokerage firm. It became entangled in several scandals and was merged into Shearson Lehman Brothers in 1988. Later, the 'Hutton' unit was sold to Primerica, which merged it with Smith Barney.

27 Actually, rumour has it that the average leverage of the I-banks was much higher, since they tended to bring leverage down at the end of reporting periods, then put it back on.

28 Indeed, not so long ago the traditional banks' prowess in investment banking threatened to put the I-banks out of business. It turned out that many deals needed financing to get done, and the traditional banks' ability to combine lending, advice and distribution made them powerful competitors.

29 We often hear that German is the only language containing a word with the meaning of Schadenfreude (it's capitalised in German). Perhaps, but that hardly means that Germans are the only people who experience the emotion. In English, the term 'Roman holiday' conveys the same sentiment. In Byron's *Childe Harold*, a gladiator expects to be "butcher'd to make a Roman holiday", that is, to be torn apart while the spectators enjoy watching his suffering.

30 On average, US banks were leveraged about 21X (assets to equity) at the peak, while European banks were leveraged on average 38X (with Deutsche and UBS over 50X). See Citigroup, *A Downward Spiral*, 17 September 2008. One interesting factoid along these lines is that, of the roughly $300 billion in credit default swaps sold by AIG, $235 billion was purchased by non-US banks as a way to leverage themselves. See Gretchen Morgenson, 'A.I.G., Where Taxpayers' Dollars Go to Die', *New York Times*, 8 March 2009, Sunday Business, p. 1.

31 It was a Swiss bank, of all things (UBS), that most enthusiastically underwrote and sold Auction Rate Securities and whose executives appear to have behaved most abominably throughout the entire episode. See Greycourt White Paper No. 44, *The Financial Crisis and the Collapse of Ethical Behavior*, December 2008, page 17, note 9.

32 We especially enjoyed the spectacle of Chinese Premier Wen lecturing Americans over their profligate spending, which (saith the premier) caused the economic crisis. Wen was certainly right about the spending (though he might have added the British, the Spaniards, the Portuguese, the Greeks and the Irish to the list), but, oddly, the good premier failed to mention that the Chinese economy was only able to grow so rapidly because these profligate American spenders bought so many Chinese goods. So dependent on exports to the US (and indirectly to the US) was China that when Americans began to save a measly 4 per cent of their income for two measly quarters, the Chinese economy collapsed and 20 million workers lost their jobs.

33 It's not often remarked upon, but because so many of the great commercial nations of the world depend on exports for a huge portion of their GDP (Japan, Germany, China), the US consumer economy utterly dominates the global consumer economy: the US consumer economy is larger than the next six consumer economies combined. As the US consumer goes, so goes the global economy.9

34 Reported in the *New York Times*, 8 March 2009, 'These Things Went From New to Much Used', p. 2.

35 The only 'invention' among the top 20 that might arguably have been invented elsewhere was 'microfinance'. But even this is probably the result of a misunderstanding. Most people associate microfinance with Hernando de Soto and Muhammad Yunus, but microfinance grew out of the micro credit movement which dates back at least to the 15th century, when Franciscan monks organised community-oriented pawnshops in Italy. It's hardly an idea developed within the last 30 years.

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