White Paper No. 46

Is It Different This Time?

Greycourt

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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," i.e., traditional valuation metrics were so outmoded that what appeared to be preposterously high prices were actually very attractive. 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 twenty 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 recognize 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 thoughtful, gray-haired investors (like us, if we hadn't been in grade school at the time) rolled their eyes and assured anyone who would listen 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.

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But it didn't happen. For fifty long years dividend yields stayed stubbornly below bond yields, and investors (like the thoughtful, gray-haired fellows just mentioned) 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." But many experienced, gray-haired investors (like us) are rolling our eyes and insisting, "Nonsense, 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? Weren't we wrong in 1958? Who's to say we're not wrong today? 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 and in several additional papers that will appear over the next few months. For example, we will articulate the assumptions on which our (and most other advisors') long-term investment advice is based and will then ask ourselves whether, based on recent events, any of those assumptions should be revised. We will look specifically at the long-term risk, return and correlation assumptions we use in our asset allocation modeling, and ask, again, whether and how those assumptions might be affected by the economic crisis and associated market events. We will address an issue that is on almost everyone's mind: how can portfolio modeling exercises take extreme events into account without imposing unacceptably large opportunity costs on investors? Finally, we will review each asset category individually to examine future prospects for those sectors – especially sectors, like hedge, that disappointed in 2008.

The "Core" Core Investment Assumption

But before we turn to our review of the core investment assumptions we and other advisors use, we want to address one assumption so central to the successful management of capital that it deserves a separate paper of its own. Although it is rarely articulated, that assumption is that *most of the commercial nations of the world will continue to conduct their affairs broadly in accordance with free market principles*. Unless this assumption holds, virtually everything we think we know about the investment process can be tossed out the window. The reason the vitality of capitalism matters so much is that, whatever its faults, capitalism allocates capital in a society more efficiently than any other known form of economic organization. And if capital is going to be allocated far less efficiently in the

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future – if it is to be allocated, for example, via the give and take of the political process – then we will all need to own portfolios that look very different from those we have owned in the past.

And, as everyone knows who hasn't been in a coma, 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 recognize the difficulties associated with a discussion of free markets in the current, dire environment, when everyone is exceedingly negative, many are exceedingly angry, and very few are thinking rationally or objectively about recent events or their likely implications. Behavioral economists have, after all, created a vast literature describing the non-rational behaviors 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. Huge market bubbles and devastating market crashes are caused, according to our behavioral friends, not by stocks or stock markets but by human nature. Specifically, so-called "herding behavior" causes most investors to become wildly optimistic at precisely the time we should be pessimistic, and to become wildly pessimistic at precisely the time we should be optimistic. Our collective enthusiasm creates stock market bubbles which we climb aboard and ride until they burst. Our collective pessimism creates stock market crashes which we bail out of and stay out of for too long. We would be a lot wealthier if we behaved in exactly the opposite way.

An analogous problem is the weird phenomenon that occurs when individuals act rationally in their own interest, yet end up causing a calamity. Garret Hardin's famous environmental parable, *Tragedy of the Commons*,[6] captured this riddle, and we see it again and again during periods of extreme market sentiment. For example, in the first quarter of 2009 surveys showed that 50% of American workers feared they could lose their jobs as a result of the economic crisis. In the aggregate – at the level of the "herd" – this is flat-out preposterous: even at the bottom of the Great Depression unemployment never reached even half so high. But at the level of the individual worker, the fears are perfectly rational. Maybe unemployment will only rise to 10% or 12%, but it will certainly rise, and no one can know whether he or she will be among the lucky 90% or the unlucky 10%. Therefore, workers behave prudently, cutting back on day-to-day spending, postponing major purchases, and pulling their money out of the stock market. Result: economic disaster, the very thing the workers fear most.

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. Which is what we propose to

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do in this paper. As we walk through the various concerns investors have about the vitality of capitalism, we will make frequent resort to the past. We know, of course, that history rarely repeats itself, but outcomes that regularly followed periods of difficulty in the past will suggest the direction of likely outcomes following our current difficulties. At least we will be putting the odds on our side, which is what the investment process is all about.

Concerns about capitalism

Although virtually every aspect of the free market economic system has come under scrutiny recently, there are five main concerns about the continued vitality of capitalism:

1. The possibility that the policy initiatives of Treasury and the Fed won't work and we will be plunged into the Great Depression II.

2. The possibility of increased, and counter-productive, regulation of financial institutions domestically and abroad, thereby decreasing the efficient flow of capital to people and enterprises.

3. The deleterious effect of government ownership and/or control of many financial firms.

4. The enfeebled status of institutions, especially investment banks, that were formerly at the very heart of capitalism.

5. Broad global disgust with the "American" version of capitalism (read "unbridled," "cowboy," "out-of-control," etc.) that is widely believed to have caused the current financial crisis.

Let's take a look at each of these concerns in order.

Capitalism Redux? Or Capitalism RIP?

1. Policy Failures in Dealing with the Current Crisis

No one who has spent much time observing the antics of the Fed and Treasury over the past twenty months can have much confidence that their efforts will prove very effective at bringing the current crisis to a quick end. 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?

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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 (although, of course, many people *think* they know). We discuss this issue below. 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 – organized way back in 1694[7] – 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 hop into our Time Machine, shift into reverse, and 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 unsalable 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

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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 rumors. 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)[8], 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.[9]

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[10] in Washington, DC. These principles are:

1. *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. Note that we don't mean that policymakers should exhibit extreme confidence that any particular policy strategy will work – therein lies disaster if the policy fails. What policymakers need to do is to act in such a way as to inspire in the public confidence that the policymakers will do whatever is necessary to resolve the problems and that policymakers aren't themselves in a panicky swoon.

2. *Be consistent*. Markets hate uncertainty, and policies should not be adopted until they have been thoroughly vetted. Once a policy is adopted – in this case, the rescue of Barings

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Bank – it must be pursued without the sort of equivocation that surprises markets, discourages investors, and destroys confidence.

3. *Emphasize 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."

4. *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 reorganized as a limited liability company; the financial losses to the Barings family were severe; Barings' position in the banking world plunged, never to recover. As Revelstoke's brother, Tom Barings, put it, "The name and the glory and the position and everything is gone, [lost] to [Revelstoke's] insatiate vanity and extravagance."[11]

But let us now settle again into our Time Machine, shift into warp speed and travel ahead 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:

1. *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. Then Congress voted in favor of the bill, and the crisis deepened further. The Fed and Treasury, far from instilling confidence, infected everyone else with their own sense of panic.

2. *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.

3. *Emphasize transparency*. From the very beginning, the Fed and Treasury 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. (The AIG mess is merely Exhibit A in the huge pantheon of policymaking opacity.) Small wonder that most people assumed the Fed and Treasury weren't talking because they were clueless.

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4. *Demand accountability*. We need hardly even address this point, given the outrage with which Congress and the American people (and their new President) 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. At the end of the day, however, what matters for the crisis to be brought to an end is the actual policies our economic leaders produce. Let's turn to that issue.

The soundness of the government's policy initiatives

We wish Messrs. Bernanke, Paulson and Geithner had behaved better, but as just noted 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 complicated 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.[12] Prisoners of prevailing economic wisdom, they starved the US and European economies of credit and capital (in large part by insisting on a return to the gold standard) 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. In Japan in the 1990s, policymakers weren't quite such dolts, but the nature of Japanese society caused the central bank and government to proceed far too cautiously for far too long, resulting in the "Lost Decade" in Japan, i.e., a period of economic stagnation that lasted roughly as long as the Great Depression.

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." And certainly they have moved more decisively than the Europeans, who now find themselves behind a very large and growing 8-ball.

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

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these initiatives is perfect and all were late in coming online, but their accumulative 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 stabilizing) 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.

The more important point is that the US economy is only doing what it needs to do to get back to a sustainable size. It will accomplish that by actually shrinking at first and then by growing more slowly. It will be a painful period, but it is absolutely necessary and there is no way to do it painlessly. Think about how we got here. Policymakers initiated and maintained policies that created a gigantic *liquidity* bubble.[13] The private sector enthusiastically went along, using cheap liquidity to bid up asset prices globally, creating a gigantic *asset* bubble. Now those bubbles have burst and prices across the board have to return to earth. They will probably over-shoot (almost certainly, the equity markets will over-shoot, as the credit markets have already done). But recession – to say nothing of depression – is not the natural condition of a market economy. Once prices become reasonable, people will buy, whether they are buying bonds, stocks, televisions or houses. There is a massive amount of capital sitting on the sidelines, and it is simply waiting for the confidence to acquire those bargains. Obama's job is to create the conditions of confidence that will allow that capital to go to work, and unless he and his policy advisors start doing surpassingly stupid things, we think they'll be successful.

In short, the US and other nations will continue to make policy mistakes for the simple reason that no one knows exactly what to do. But we are confident that those mistakes won't be remotely egregious enough to force a naturally animal-spirited market economy into a permanent tailspin. If Obama keeps America's spirits up and the Fed and Treasury keep pushing forward in what is generally the right direction, we will be out of the woods sooner than most people now believe possible, and investors who are betting otherwise will likely rue the day they did.

A note about the Europeans

In Europe, centrals banks and governments have been far too slow to recognize the seriousness of the crisis – the European Central Bank was still *raising* interest rates as late as last summer – and now that it's nearly too late they have found that their tools for dealing with it are meager, indeed. 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 twenty-seven governments (!) making

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contradictory decisions. With Eastern Europe on the very edge of meltdown,[14] 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 favor 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 – and different economic prospects[15] – 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.

Thus, the problem is not understanding why the Europeans are behaving the way they are, the problem is that their perfectly understandable behavior is likely to have a negative effect on global economic recovery, just as the perfectly understandable behavior of the Americans is likely to result in serious inflation down the road.[16]

2. 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.[17]

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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.

Already there is broad consensus that policy failure at the Fed level – creating and allowing to persist a massive liquidity bubble – was at the core of the current crisis. But we would go further. Except possibly in Silicon Valley, no industry sector has evolved as rapidly as the financial industry over the past twenty years. The combination of massive brainpower[18] and massive computational power, focused by the lure of huge profits and stunning levels of personal compensation, has created an industry that churns out new products at a rate that firms in the industry themselves have trouble staying on top of. It's one thing, for example, to recognize the profit potential in, say, residential mortgage-backed securities (RMBS) or collateralized debt obligations (CDOs), but it's another thing altogether to understand the risks such securities bring with them.

It wasn't, for example, the collapse of the subprime mortgage market that caused such chaos, but the fact that subprime 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 subprime 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 securitization and collateralization.

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 nationalization 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?

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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. For example, there is a major stampede to create a “systematic risk regulator,” and most suggestions put the Federal Reserve in this position. But we would modestly point out that the Federal Reserve is headed by a guy who denies that bubbles are possible and who thought that housing prices merely reflected the strength of the American economy. Is that the sort of hands we want to be in?

Whatever the “systematic” regulator turns out to be, it’s highly unlikely to over-constrain the competitiveness of the US financial system. 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. Regulation proposed by the Treasury Department seems 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 (as the Recent Unpleasantness taught us). 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 re-create the US financial sector in the European mold, i.e., with governments in control of the allocation of capital.[19]

Serious policy mistakes in the past

In any event, in the real world, as opposed to the world of our recurring nightmares, 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.

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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 who 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.[20] 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 favor 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 reactions 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,[21] 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. (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.) 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 (we are up to King Louis XV by 1720) to respond to public

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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 favored 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.[22]

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 industrializing island. France, meanwhile, was starved for capital, and its growth lagged far behind that of England. Indeed, except for the brief years before Waterloo,[23] 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% 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."

3. Government Control of Core Financial Institutions

As noted above, 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. However urgent it may have been for the state to intervene at these levels, the facts on the ground are that several of the larger US financial firms are now controlled by the government, directly or indirectly, and flat-out nationalization of the banks is clearly a policy option, albeit not one anyone wants to mention out loud. It's hardly a wonder that people worry about a socialized financial system and its dire implications for investment strategies and outcomes.

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But there are two compelling reasons to believe that our financial system isn't about to be nationalized.[24] The first is that nationalization is an ugly word in America. Merely mentioning it as a policy option sends the markets reeling downward and the mentioner backpedaling as fast as he can. When Senator Dodd brought the subject up, Geithner and even Bernanke himself took pains to distance themselves from the Senator, who himself promptly backed down. Dodd was actually right – at least temporary nationalization of the largest, weakest banks certainly should be considered as an option, and we will be surprised if it doesn't happen at some point.[25] But Americans are allergic to the word and idea of nationalization, and even if nationalization 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]ationalization 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 nationalization. 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 a 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. 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.[26]

Given our hypersensitivity to nationalization and the lack of need for it on a broad scale, we don't view government control of the banking sector as an issue worth losing sleep over.

4. 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. To which we say, along with General McAuliffe, "Nuts!"[27]

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The wholesale collapse of uncompetitive firms has always been a hallmark of the financial industry, which (along with the technology sector) well illustrates the "creative destruction" aspect of capitalism. In the 1980s and early 1990s, for example, seven hundred and forty-seven (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."[28] 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),[29] 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. Free-standing, 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 molder: at JP Morgan, Citigroup, Bank of America and other institutions, highly competitive[30] I-banking functions developed in competition with the Goldmans, Morgan Stanleys, Lehmans, and Bears.

We wouldn't hazard a guess about what the future I-bank sector will look like – oh, hell, of course we would! After all, we already know something about how one kind of financial service model substitutes for another, because by about 2006 traditional banks were

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responsible for less than half of all lending activity in the US. The other half came out of the "shadow" banking system, which encompassed private equity firms, hedge funds, prop desks, SIVs (structured investment vehicles), mezzanine lenders, collateralized products, and so on. So here's our guess about how the activities formerly conducted by the late, unlamented investment banks will be conducted in the future.

First, the former swashbucklers, at least those that are still in business, and the traditional banks will continue to engage in the investment banking business as before. The main difference between the Swashbucklers of 2007 and the Good Citizens of 2009 is that leverage has gone away and will stay away: this activity will now take place under the provisions of the Bank Holding Company Act, which limits the amount of leverage and other fun activities the firms can engage in. Financial engineering will continue to occur among these firms – recall that credit default swaps were invented at JP Morgan – but most of the edgier activities, including leveraged proprietary trading, the creative packaging of structured financial products, and other creative and sometimes alarming activities, will likely be conducted by firms that look like a cross between today's private equity firms and today's hedge funds. They may operate with very substantial amounts of capital, but will be lightly regulated (albeit more heavily regulated than they are today) and will be organized as partnerships in which the decision-makers' capital is managed alongside that of the investors' capital, or occasionally as incorporated entities in which the decision-makers own a large chunk of the equity (and if they don't, run the other way). This transformation is already well underway, as major figures are leaving the semi-socialized big banks and the lobotomized former I-banks to join nimbler boutiques or start their own firms.[31]

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

5. Distaste for American-Style Capitalism

When the Debacle of 2008 began in the US, schadenfreude[32] 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[33]). It also became quickly obvious that a US Bear Market and a US recession meant catastrophe for European and Asian markets and economies (so much for the "decoupling thesis).[34]

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

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enthusiastically adopted these practices, and sometimes (as with auction rate securities) even "improved" on them,[35] 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 (yes, 20th) century: you need to build modern infrastructure. In other words, you instruct your peasants (nicely, but on pain of death or banishment) 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 industrialized nations of the world. We know how this works because in the movie we saw the Soviet Union do 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.

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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 ("The Rise and Fall of the Soviet Union"). 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,[36] 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.

In fact, the likelihood that the Chinese, at least, will stop grumbling about nasty capitalists is even greater than we've just suggested. China needs capitalism in China, but China also needs capitalism in the US and Europe. Unless those unreconstructed Western economies recover and grow rapidly, there will be no one for China to sell to.[37]

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 twenty greatest inventions of the past thirty years, ideas like the personal computer, the Internet, and so on.[38] Can you guess how many of these critical inventions were Made in America? The answer is 19.5 of them.[39] 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.

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When We Were Young…

In the early summer of 1974 we sat in a vast, cherry-paneled conference room and took notes (that was our job) as the patriarch of one of America's great families addressed his adult relatives. His purpose in summoning the next two generations was to explain why it was that he had just instructed the family's trustees to sell all their stocks and to invest only in bonds and cash. The patriarch acknowledged that all across America panicked investors were dumping stocks in an hysterical frenzy, but he wanted to emphasize that this was not what he was doing. He had given the matter much thought, was proceeding in a calm and orderly manner, and his only regret was that he hadn't acted sooner.

The patriarch reminded his family that he had had the great privilege to come of age during America's brief period of greatness, when the country had emerged from a devastating depression to win the Second World War and would go on to build an economy that was the envy of the world. But somewhere along this happy road, "America lost her way." The patriarch dated the troubles to Lyndon Johnson's administration when, out of the best possible motives, America determined to build a Great Society and win the War in Vietnam at the same time. We failed on both counts, and America's confidence in itself had collapsed.

The failure of confidence could not have come at a worse time, the patriarch continued, because America had already lost its competitive edge. American corporations had become complacent, inefficient and lazy, burdened by so many layers of management that it literally took years for even the smallest decision to get made and implemented. Labor-management relations in the US were appalling, with strikes, lockouts and outright violence now commonplace events. America could no longer compete in the world markets, and our economy was in any event being bled to death by inflation, which was rising every month and showed no signs of abating.

Meanwhile, Germany and Japan were out-competing us on every front, and it was easy to fix the year when both those economies would surpass the US in size. Germany and Japan were forging a powerful east-west axis that should cause serious foreboding for anyone who remembered the military aggressiveness of those societies. And that was only in the Free World! Behind the Iron Curtain the Soviet Union was more powerful than ever. The Soviets had promised to "bury" America back in the 1950s, and they were now proceeding to do so. Every year, more and more countries (including, of course, Vietnam) were being drawn into the powerful Communist orbit.

No one, the patriarch pointed out, should be surprised by any of this. Every great civilization followed the same trajectory: they began in obscurity, grew to dominance,

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became smug and complacent, and then the inevitable terminal decline set in. It had happened to Egypt, Greece, Rome, Persia, Britain, and now it was happening to the US.

The patriarch acknowledged that there was nothing he could do about the decline of America, but there certainly was something he could do about the decline of his family's capital, and he had done it. Other families might stubbornly stick with their stocks and watch their wealth disappear, but his family could sleep soundly at night knowing their capital was safe. When the patriarch finished speaking, his family burst into applause, grateful that their fate was in such competent and thoughtful hands.

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We know, of course, how this worked out, both for the patriarch's family and for America. For the family, the patriarch's decision was a cosmically tragic error. By 1985, the family was poorer than they had been in 1965. And that was in absolute dollars. In inflation-adjusted terms, the family's buying power had dropped by two-thirds. And since many more family members had been born than had died over those two decades, the per capita wealth of the family was a small fraction of what it had been. In the 1960s, the family was a dominant presence in its home city and was known and admired across the US and Europe. By the turn of the 21st century, no one knew their name.

And as for the patriarch's view of America's future, he proved to be as wrong as it is possible for a man to be. Germany, Japan, and the USSR turned out to have their own deeply entrenched vulnerabilities, and the patriarch had vastly under-estimated the ability of America to clean up its uncompetitive act. Instead of Germany and Japan surpassing the US in size, by the turn of the century the US was twice as large as those two economies combined, and the gap was getting bigger every year. We all know what happened to the Soviet Union. How could the patriarch, an intelligent, thoughtful, sophisticated man, have been so utterly wrong?

We go back to the behavioral issues with which we launched this section of our paper. In 1974 everyone, including the patriarch, was surrounded every minute of every day with negative sentiments. The patriarch sincerely believed that his views on the future were sound, but time would soon reveal them to be something emanating from the lunatic fringe. Though he appeared calm, in fact he was simply better at articulating his panic than were retail investors. Because he was vastly more influenced by his environment than he understood himself to be, he seriously over-estimated the likelihood that his views of the future would prove to be accurate. Instead of being plausible, these views represented a 100-to-1 shot. Finally, imagining that he was betting on a sure thing, he took drastic action with his family's capital. Each step in the patriarch's thinking, leading up to the sale of all his equities, seemed rational to him. But in fact he was simply lost in a fog of pessimism and he destroyed his family's capital.

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These, then, 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 we, and most other 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.

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[1] Even in the darkest of those times – 1932 – investors who bought well-diversified, equity-oriented portfolios achieved gains of nearly 280% over the following four years. Of course, certain strategies fared badly during the Depression years. The great Benjamin Graham, author of

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"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 November 20, 2008, the yield on ten-year Treasury bonds was 3.01%, while the average dividend yield on the S&P 500 stocks was 3.45%. In April of 2009, the yield on ten-year Treasuries was just under 3%, while the dividend yield of the S&P 500 (including only stocks that paid dividends) was 3.3%. 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 (October 17, 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] Hardin imagined a village in which every resident had the right to graze his cows on the village common for free – after all, no one "owned" the common land. It was therefore in the interest of each resident to graze as many cows as possible. Eventually, the carrying capacity of the common was breached, the cows died and the villagers starved.

[7] Interestingly, the impulse behind the organization 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.

[8] In 2006 Britain's trade deficit exceeded 4% of GDP, finally surpassing the record set in 1697.

[9] 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.

[10] 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.

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[11] Quoted in Smith, op. cit., p.90.

[12] 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).

[13] And let's not forget that while the easy-money policies of the world's central bankers may be in disgrace at the moment, they fed the most rapid improvement in living standards globally that that the world has ever seen.

[14] 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.

[15] 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.

[16] 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.

[17] 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%, +22%, +89%, +74%.

[18] The top MBA and law school graduates have been entering the financial industry in droves for years.

[19] 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.

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[20] 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 industrializing 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 organized in Antwerp in 1531.

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

[22] 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* centralized and bureaucratized capital in Germany, eventually creating the complex cross-ownership ("diagonal" share holdings) that today link nominally independent firms and exclude the public.

[23] 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!"

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

[25] Of course there are huge downsides, but nationalization 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-privatize them. The really important downside might be the impossible-to-resist temptation for the government to operate the banks for political reasons.

[26] The government's quirky and highly-politicized "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.

[27] For those of our readers who may be a bit dim on their World War II history, then-Brigadier General Anthony McAuliffe was the commander of the 101st Airborne unit at Bastogne during the Battle of the Bulge. When the surrounding German forces formally demanded the surrender of the town, McAuliffe sent back his famous one-word reply: "Nuts!"

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[28] 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.

[29] Actually, rumor 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.

[30] 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.

[31] Examples include Michael Mayo, former star analyst at Deutsche Bank (moving to boutique CLSA), and Meredith Whitney, former star analyst at Oppenheimer (launching her own shop). Even the Goldman Sachs banker who famously advised Warren Buffett, Byron Trott, has left Goldman to launch BDT Capital Partners. See also "Eat-What-You-Kill Bond Traders Rise From Wreckage," Bloomberg.com, March 24, 2009, and "Independent Firms to Prosper," Wall Street 2.0, February 1, 2009.

[32] We often hear that German is the only language containing a word with the meaning of Schadenfreude (it's capitalized 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.

[33] 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," September 17, 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, March 8, 2009, Sunday Business, p. 1.

[34] Exactly why this should have come as a surprise is a mystery to us. If you add up the Japanese, German, Chinese and UK economies they are, taken together, smaller than the US economy.

[35] 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.

[36] 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

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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% of their income for two measly quarters, the Chinese economy collapsed and 20 million workers lost their jobs.

[37] 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

[38] Reported in the New York Times, March 8, 2009, "These Things Went From New to Much Used," p. 2.

[39] The only "invention" among the top twenty 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 microcredit movement which dates back at least to the 15th century, when Franciscan monks organized community-oriented pawnshops in Italy. It's hardly an idea developed within the last thirty years.

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