FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Boom and Bust

Arguably the most interesting stories about investing are those about financial booms and busts. They include many aspects of the human experience: innovation, misguided and corrupt politicians, story telling, deception, herd mentality, greed, folly, panic, despair and the School of Hard Knocks. The anecdotes about unprecedented situations and extreme behavior are both shocking and amusing.

But as an investment advisor, I am primarily interested in the causes and consequences of booms and busts, as they have occurred repeatedly (so we should be able to learn from them). In an age of central banks and fiat currencies, their frequency has increased from about once a century to about once every six years, as central banks overcorrect by "doing whatever it takes" to recover from their last self-imposed crisis.

I just finished reading the book Boom and Bust: A Global History of Financial Bubbles by William Quinn and John Turner (4 stars), which was published in 2020. The authors' central thesis is that a bubble is ignited by a political or technological spark, but requires marketability, easy money/credit, and speculation to become a conflagration.

The authors write that financial innovations (such as mortgage-backed securities) or the legalization of certain types of financial assets (such as the new Bitcoin ETFs) often precede bubbles. Additionally, increased participation in the market for the bubble asset—which expands the potential pool of buyers and sellers—is often a characteristic of bubbles.

Easy money and credit—which the world has had to an unprecedented degree and duration since the Great Financial Crisis in 2008—fuels the bubble in two ways. First, investors can use cheap borrowed money to buy the bubble asset. And “because banks are lending other people's money and borrowers are borrowing other people's money, neither are fully on the hook for losses if an investment in a bubble asset fails.”

Second, low interest rates on traditionally safe investments drive investors to reach for yield in risky assets. The authors quote Walter Bagehot, writing in 1852 that the typical Brit “can stand a great deal, but he cannot stand two per cent....Instead of that dreadful event, they invest their careful savings in something impossible—a canal to Kamchatka, a railway to Watchet, a plan for animating the Dead Sea.” The authors write, “Investors would...rather invest in something ridiculous than accept a low interest rate on a safe asset.” So investor impatience contributes to the formation of bubbles.

Speculation—investing that is solely motivated by the prospect of a capital gain--is the third requirement for a bubble. “During bubbles, large numbers of novices become speculators, many of whom trade purely on momentum....” Whenever the local tennis pro starts talking about a popular investment, or a neighbor quits his job to become a day trader, or a neighbor runs out of his house to excitedly tell you, “I think Bitcoin is going to a million!” (all of which have happened to me), watch out, because the end is near.

According to the authors, “Technological innovation can spark a bubble by generating abnormal profits at firms that [make] the new technology, leading to large capital gains in their shares [which] then attracts the attention of momentum traders....excitement surrounding [the new] technology leads to high levels of media attention, drawing in further investors. This is often accompanied by the emergence of a 'new era' narrative, in which the world-changing magic of the new technology renders old valuation metrics obsolete, justifying very high prices.”

The spark for a bubble can also be provided by government policies, usually in the pursuit of a specific goal. For example, several housing bubbles have been sparked by the desire of politicians to increase home ownership.

The financial bubble was invented around 1720 by the French and British governments as a way to reduce their heavy debt level. In France, John Law—who created the Mississippi Company and later became Finance Minister--“was able to use the news media, which was...subject to strict political control, to stimulate demand” and spread propaganda and lies. Interestingly, as the bubble began to pop, the government started printing massive amounts of currency and passing laws that sought to prevent citizens from using gold, silver and even diamonds. Something to remember, as history repeats itself.

The authors note that “The South Sea Bubble similarly arose from the British government's desperation to get its debt under control." Its scheme, "which borrowed heavily from Law's ideas...[offered] equity to the public in exchange for government debt."

Next, the authors examine the first emerging markets bubble, which started around 1824 and focused on mining companies in Latin America. According to the authors, "624 [new mining] companies were [floated] in 1824 and 1825. But by the end of 1826, only 127 of these were still in existence—the remainder had either been abandoned, failed or had never got far beyond publishing a prospectus." One engineer/manager "published a devastating account of their failure in 1826," citing three reasons.

First, the physical difficulties of getting machinery, men, provisions and materials to remote mines—roads were poor, rivers often impassable and mines were usually miles from the nearest port....Second, locals were unwilling to work and to adhere to contracts, most Cornish workers were permanently inebriated and...mine managers could easily steal the proceeds. Major disputes over pay broke out [and] the resulting strikes were prolonged and violent." Third, Latin American nations suffered from expropriation, political instability, corruption and economic difficulties. This is a great reminder that for every pie-in-the-sky story about huge, easy profits, usually there are many obstacles in the real world that prevent that from happening.

Back then, a company had to petition Parliament in order to incorporate. "MPs [members of Parliament] were [often] shareholders in companies and yet were able to sit on the committee that examined incorporation bills," which created huge conflicts of interest. "MPs were often recruited to be directors of these new companies to give them an air of respectability."

The chapter called "Casino Capitalism with Chinese Characteristics"--about the two recent bubbles in China—was amusing, and another example of how when the Chicoms do something, they go *all in*, on a massive scale, regardless of the absurdity or devastating consequences, whether it's building backyard furnaces, targeting sparrows, building enormous ghost cities, or starving 45 million people.

In 2005, the Chinese government wanted to sell its massive holdings in state-owned enterprises to the public, so "authorities needed to manufacture an ebullient stock market," which was "cheered on by the state-controlled media." Due to the lack of a social security system, capital controls, and very low deposit rates at state-owned banks, Chinese citizens were left with "the stock market as the only viable alternative."

The authors write, "In the first four months of 2007, 10 million new retail investors opened accounts, more than had done so in the previous four years combined." Many new investors were uneducated (two thirds had not completed high school) and complete novices. Many of these common folk gave up their jobs to become day traders. Many had incredibly naïve or bizarre investment strategies, relying "on a mixture of rumors, numerology and *feng shui* to help them" pick stocks.

After the Great Financial Crisis, the Chinese government pursued "a massive stimulus program whereby banks and shadow banks began lending to corporations, small businesses and individuals....As a result, China's non-government debt rose from 116% of GDP in 2007 to 227% in 2014." By then, the government was worried about "the level of debt and the precarious nature of the shadow banking system...and slowing economic growth and the threat that this posed to their political legitimacy and stability." So it engineered another stock market bubble. What a strange vehicle for a Communist Party to use. But at the same time, they just can't help themselves—they have to interfere with market processes.

The authors write, "In order to attract retail investors, the state-controlled press...ran laudatory editorials extolling the virtues of the stock market....This propaganda mill went into overdrive to encourage people to put their savings into the stock market....The state even...[paid] internet commentators to comment favorably on the economy and stock market."

The government encouraged companies to list their shares on the stock market, and the number of listed firms mushroomed as a result. "New IPOs often generated a great deal of excitement....In an attempt to cash in on excitement about new technology, 80 listed companies changed their name...to give themselves more of a hi-tech aura" even though they had nothing to do with high tech. Of course, this all ended in disaster, but the Chinese Communist Party blamed the bubble on the head of the stock market regulator.

The book also includes chapters about the Great Railway Mania in Britain, the Australian Land Boom, the British Bicycle Mania, the Roaring Twenties and the Wall Street Crash, Japan in the 1980s, the Dot-Com Bubble, and the Subprime Bubble.

The authors examine the media's role in the creation of bubbles, and conclude that its function "as a financial watchdog can easily be undermined, for four reasons. First, news media reporting is shaped by consumer demands....Competition forces newspapers to give readers what they want." (Which is not analysis but a compelling narrative and justification and encouragement to overpay for richly valued assets.)

Second, journalists often don't have the knowledge or time to understand and report on complex information. "Third, journalists often build *quid pro quo* relationships with their sources where, in return for a positive spin on a favored company, government or individual, they get access to private information....Fourth, the incentives of the news media can be distorted by advertising revenue. If they become over-reliant on advertising revenue which is linked to the boom in asset prices, then their incentive is not to prick the bubble, but to puff it."

In conclusion, usually bubbles simply transfer a massive amount of wealth from certain groups of people (novice and greedy investors, the naïve and uninformed) to other groups of people (insiders, shrewd investors politicians, the corrupt, promoters and swindlers), often leaving enormous and long-lasting financial, economic and social destruction in their wake.

Not only are the political objectives that sparked a bubble not achieved, the resulting crash makes things even worse than they were before. For example, "...the policy of extending homeownership [in the 2000s] was a total failure: in the case of Ireland, the UK and the US, homeownership rates in 2015 were *below* those in 1990. The fall in house prices…disproportionately affected poor homeowners and wiped out most of their wealth." Every government program results in the exact opposite of its stated (or sincere) goal.

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