

The Fire Next Time?

“The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not just an illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait” -- G.K. Chesterton, *Orthodoxy*

The financial services industry loves to pretend the world is orderly and regular – insurance projections and detailed financial plans perpetuate the delusion that you can predict your net worth on July 8, 2015, carried out to two decimal points. It makes it easier for them to sell their products. Academics create models assuming the future possibilities are bounded, like a blackjack game with a single 52 card deck, forgetting about the occasional joker. On a larger scale, investors are persistently surprised that at entire “deck” changes from, say, the late 1990s to the past three years.

Our thoughts about periodic market disorderliness were sparked by the fifth anniversary of the financial world almost incurring a catastrophic flood of debt defaults, the result of the collapse of a previously obscure investment partnership named Long-Term Capital Management (“LTCM”). LTCM’s investments were primarily derivatives they created, contracts that derive their value from bonds, stocks or other assets. The firm had enlisted a group of intellectually high-powered mathematicians, including two professors who were about to win the Nobel Prize. The LTCM team quietly directed vast assets, mostly borrowed from banks, and even larger amounts of financial exposure from its derivative contracts, which are akin to side bets on movements in market prices.

The financial services industry loves to pretend that the future can be predicted with great certainty.

With extreme leverage, or borrowed money, one slip can result in disaster. Investing without leverage is like walking the length of a wooden plank lying on your living room floor. Investing using leverage is like walking the same plank suspended between two towers 500 feet in the air. The width of the plank is the same, but it becomes much more difficult and risky to complete your walk.

The impact of leverage was made worse by the creators of the derivatives not understanding how the contracts would be priced in real market conditions. This reminds us of a Disney cartoon on the history of aviation, in which Goofy flies a plane in World War I, chivalrously waving to his enemy flying by. One

day, the guy in the other plane makes an unpleasant gesture, and the animosity escalates into brick throwing and firing of pistols. In a fit of pique, Goofy mounts a machine gun on the fuselage of his plane, flies off in search of the enemy, and promptly shoots the propeller off his own plane. Creators of derivatives may be like Goofy in the cartoon – recklessly developing new methods and inventing new products that prove to be unsound. Smart as they were, LTCM’s derivative creators did not know what they had wrought. The market conditions that stressed the LTCM investments had also occurred as recently as 1987 and 1992, but the models the professors were using didn’t extend their data back that far. This wasn’t a case of a house being washed away by the 100-year flood, but by an ordinary winter storm.

Banks, always susceptible to group-think, were impressed by LTCM’s academic pedigree and early success. They competed with one another to take the other side of the LTCM derivatives contracts and to shower loans upon the partnership to finance the purchase of risky assets they did not understand. The banks can try and offset exposure in one market direction (e.g., against a rise in interest rates) with offsetting contracts in the other direction, but if the other party to the offsetting contract fails, they are subject to the original risk.

The little known hedge fund for wealthy investors needed to be saved, but the nuclear power was allowed to default.

The market conditions that led to LTCM’s demise were sparked by Russia defaulting on its government debt. The Federal Reserve realized that the partnership’s leverage and suddenly unmarketable derivatives had resulted in a daisy chain of potential defaults throughout the U.S. banking system. The Fed hastily arranged a bank bailout of LTCM. Yes, that is right – it was determined that the financial system could withstand the default of Russia, a nuclear power, but not LTCM, a private hedge fund for wealthy investors. The banking crisis was averted, and the gunning of the money supply by the Fed helped fuel the manic stock market boom of 1999. The moral hazard of protecting market players from the consequences of stupid decisions was increased. In crises, the risks are urgent; the perils of addiction are subtle, longer lasting and perhaps more dangerous. Permitting losses and failure is what deters others from taking inappropriate risks.

Five years later, the level of notional derivatives exposure in the U.S. banking system has roughly doubled. The number of hedge funds has exploded. There may be no problem, or there may be another failure that could act as a spark for a debt conflagration just around the corner.

Nobody really knows what caused the 1918 influenza epidemic – it just burned itself out. Five different groups of academics “know” what caused the Great Depression, but they disagree and think the “competing” causes are idiotic. If you do not know the cause of or cure for an event, you risk being unprepared for a recurrence. If you would like an advisor cognizant of the occasional “wildness in wait,” give us a call.