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The Only Thing New is the History You Haven't Read

"An exact knowledge of the past [is] an aid to the understanding of the future, which in the course of human things must resemble if it does not reflect it...."

Book 1, Section 22, The Peloponnesian War, Thucydides

Thucydides, the first "scientific" historian, evidently felt that civilization was at least somewhat continuous, cyclical and repetitive. This led him to believe that a study of history was of value to present endeavors, not just satisfying a casual curiosity. Nobody disregards the past more, however, than financial pundits claiming we are in a new era in which historical stock market cycles can be ignored.

"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience"
-- George Bernard Shaw

In our daily lives, our brains constantly (and usually unconsciously) extrapolate the recent past. If it's raining today, it's likely to rain tomorrow. If we like a TV show this week, we are likely to watch it next week. If we made money on our last

purchase of a technology stock, we are more likely to favor technology in our future purchases.

This extrapolation is often helpful and legitimate. After all, if you are hiring an employee and she has been successful in her last two or three jobs, you expect her to be successful in your employment as well. You would not expect her to "revert to the mean" and suddenly become stupid and incompetent. Science and technology are not cyclical -- we don't go back to bleeding patients with leeches or installing vacuum tubes in our televisions.

In other matters, however, there is not constant movement in only one direction. In rainy Oregon, a bad winter may be followed by debate as to whether we just suffered through a 10-year flood or a 30-year flood, but not whether it will continue to rain harder forever. Humans have been trying to perfect themselves for millennia, but a quick look around will tell you the process is not complete. We are imperfect, ruled by the same emotions that plagued citizens of the Roman empire

While investors often simply extrapolate the very recent past, that criticism can hardly be leveled at many of today's investors. It's hard to watch CNBC for any length of time without someone questioning if the "correction" in technology stocks is over. As this is written, the Dow Jones industry indices for technology, semiconductors, wireless communications and the Internet are down

42, 46, 53 and 70 percent, respectively, from the highs hit last March. If that's a "correction, we would hate to see what a bear market in technology shares looks like. The greed fed by several years of a bull market has dulled any sense of danger or fear in many investors. We appear to have moved from simple extrapolation to the more complex psychological phenomenon of denial.

While science and technology constantly advance, despite the talk of a new era, we believe investors are still ruled by the emotions of greed and fear, making the financial markets cyclical, more like seasonal weather than medicine. Ignorance of historical cycles can prove costly. Long Term Capital Management (LTCM), the hedge fund run by geniuses that included two Nobel laureates, failed in 1998, due primarily to an incorrect, leveraged bet that certain interest rate spreads wouldn't widen. A similar widening of interest rate spreads (driven by the interplay between greed and fear) had occurred in both 1992 and 1987, but the LTCM's models didn't go back that far. In fact, the rate spreads are now wider than they were in 1998. In other words, what wiped out LTCM was not even the result of a financial equivalent of a 30-year flood, but more like deciding that summer would not be followed by fall. It's hard to think of a better example of George Santayana's observation that those who cannot remember the past are condemned to repeat it

***" Whoever marries the spirit of the age will be widowed in the next"
-- Karl Keating***

It's easy to marvel at the ignorance of history demonstrated by the academic geniuses at LTCM, but history is often abused as well as used. Historical analogies abound in almost any crisis, but similarities and differences should both be carefully considered. The U.S. got into Vietnam primarily as a result of our presidents, who had witnessed the rise of the Nazis in the 1930's, being fearful of appeasing, and therefore encouraging, tyrants in "another Munich." In the fifteen years prior to U.S. involvement in the Gulf War, politicians and policy analysts were reticent to use military power anywhere overseas, fearing "another Vietnam."

In the financial world, a generation seared by the 1929 crash and Great Depression largely missed the tremendous bull market from the late 1940's until the late 1960's. The following generation was so stimulated by that bull market that it saw every market dip as a buying opportunity and was decimated by the bear markets that followed. Investors who came of age during those bear markets sat out much of the bull market we have enjoyed since. In investing, we must constantly guard against avoiding the mistakes of our parents only to repeat the mistakes of our grandparents.

The lessons of history are not precise or infallible, but ignoring how cycles of greed and fear have hurt investors in the past can prove expensive. Part of our job is to help clients overcome destructive emotions with a rational approach that includes a review of past market cycles. If you would like help in developing a disciplined, appropriate sense of history and perspective in your investment program, contact us.