

Things We Lost in the Bubble

“He believed in character; he wanted to jump back a whole generation and trust in character again as the eternally valuable element. Everything else wore out.”

— *Babylon Revisited*, F. Scott Fitzgerald

Fitzgerald, the classic chronicler of the Roaring Twenties, also did a fair job of describing the hangover. His semi-autobiographical *Babylon Revisited* relates the experience during the sober 1930s of Charlie Wales returning to Paris, attempting to put his life back together. Specifically, Charlie is trying to regain custody of his daughter, subtly named Honoria. He had quit his job during the stock market boom – what is the point of working if the market is making you more money than you need? Wales and his wife were exuberant participants in the dissolute Jazz Age life in Paris until reality, in the form of the Great Depression, intervened. Having lost his money, his family and his giddiness, Charlie is able to adjust to the 1930s version of the “new normal,” putting himself in better stead than many of his old acquaintances who are unable to see that everything had changed.

We live in a similar period, the aftermath of the twin bubbles of technology stocks in the 1990s and real estate in the last decade. During each of the bubbles, many otherwise reasonable people felt the allure of fast and easy money from speculation, as opposed to the less enjoyable toil of holding down a job. Just log on to your computer and day-trade your way to riches; buy several houses, apply a little paint and flip them at a significant profit. Like the notion that the Jazz Age would continue forever, though, this quick, easy money was illusory. Per Charlie Wales, let us jump back a generation and think about how normal folks would perceive modern finance. In the late 1950s or early 1960s, say, what response would you expect if you told people you stared at an electronic screen and day-traded stocks for your livelihood? Would you expect accolades if you told people that, despite having no job or assets, you were able to borrow heavily from banks to buy houses that you then attempted to resell in a couple of months? We believe people would consider you lazy, crazy or immoral.

Chasing after get-rich-quick schemes not only reflects low character, it also is silly. If you were playing poker and you suddenly realized the others at your table were champions, you likely would quit. When you log onto your computer to day-trade stocks, your opponents may be invisible, but a quick moment of reflection will tell you that you are going up against Goldman Sachs, Morgan Stanley and hedge fund traders who have been doing this for their entire careers. Why, exactly, would you believe you were going to best them in a zero-sum game?

Ordinarily, people face only one debauch followed by one hangover at a time, learn their lesson and, chastened, move on in a more rational fashion. We had just begun the recovery from the technology stock meltdown, however, when the real estate bubble took off. The Federal Reserve's easy money policy deferred but did not prevent the pain investors have felt in the past few years. As a result, there is a growing revulsion towards equities. Bond funds are seeing record inflows, while equity funds generally have seen large outflows. Investors who may have scoffed at advisers promising "only" 20 percent annual returns in the 1990s are piling into 10-year Treasury Notes offering 2.5% interest - before taxes and inflation. Like all hangovers, this one is painful.

"Sow a habit, and you reap a character. Sow a character, and you reap a destiny."

-- Charles Reade

The financial services industry also sullied its reputation in the bubbles. Think of the Bailey Building and Loan run by Jimmy Stewart's character in *It's a Wonderful Life*. If Jimmy loaned money to Mr. Martini so he could buy a house, the Building and Loan was going to hold the mortgage for 30 years. This made the decision relationship-oriented, rather than transaction-oriented.

Was Martini going to be good for the money 10 or 20 years from now? Among other things, you would be certain that Mr. Martini had both a job and the inclination to honor his loan obligation. If George Bailey could sell the Martini mortgage 2 days after putting out the money, though, Martini's employment or character might seem to be of minimal importance. Because they easily could pass on the downside of their decisions in the marvelous world of modern finance, lenders in the last decade buried residential housing in the U.S. deep into a hole that we may be climbing out of for another decade.

A successful life is not just a series of transactions; it is a series of character tests and relationships. The Jazz Age produced great music and literature, but not much in the way of moral example. We now call those who subsequently came of age in the 1930s and 1940s the "greatest generation" because they endured the adversity of the Great Depression and World War II and built modern America. Investors endured negative real returns between 1966 and 1982, coping with gas lines, stagflation, political corruption and the hollowing-out of the manufacturing base of the Midwest. At the end of that period, nobody was hoping for quick money in the stock market or quick turnarounds on a house purchase. Surviving this adversity and resetting expectations away from dreams of short-term gains set the stage for the long bull market between 1982 and 2000, by many measures the biggest bull market in U.S. history. Charlie Wales seemed to believe that character was a generation-skipping gene - we can only hope now he was correct.