

Banker Without A Cause

At the climax of the 1955 movie *Rebel Without a Cause*, the local bully and gang leader Buzz challenges Jim Stark (played by James Dean) to a game of Chicken. In the game, two drivers race stolen cars towards a cliff. The last to jump from their car is the winner; the first to jump is the chicken, and therefore the loser. The game ends in tragedy as Buzz catches his jacket sleeve on the car door, is unable to jump and plunges into the abyss. The game, relevant to the financial markets, diplomacy and life generally, has a paradox; it does not reward acting rationally, at least in the short run.

A *rational* person will jump early in chicken, not wanting to risk dying. A rational person will value their face (and the rest of their body) more than the risk of losing face. The game rewards irrationality, because your irrationality makes your opponent doubt that they can win. Imagine you are Jim Stark and, right before the race, you see Buzz guzzling liquor, hitting his head repeatedly on the steering wheel or handing his girlfriend a suicide note. You might conclude that Buzz either does not realize the risks or care about going over the cliff, and therefore you will jump out of the car sooner rather than later.

Diplomats, unsatisfied with a lowbrow name like chicken, call their version brinksmanship. In 1960, Soviet premier Nikita Khrushchev interrupted speakers at the United Nations General Assembly, shouting and pounding his fists on the table. When a delegate criticized a Soviet resolution, Khrushchev took off one of his shoes, waved it at the delegate and started banging the shoe on his desk. In the context of the Cold War and possible worldwide thermonuclear destruction, such behavior, more commonly associated with professional wrestling, sent an attitude-adjusting message to the U.S. and the rest of the free world ~ someone crazy enough to do that is crazy enough to push “the button.” Some claim that Khrushchev still had both his shoes on during the incident, suggesting that he had brought a third shoe to bang, clearly indicating premeditation on the part of the supposedly crazy Soviet premier.

Similar games are part of everyday life in the financial services industry. For example, a bond manager can buy either low quality junk bonds, paying a high yield but with a high risk of eventual default, or high quality, low-risk bonds. If all managers buy high quality bonds, their returns will be similar and everyone's clients are likely to stay put. If your competitors buy high-risk bonds and you stick with high quality, low-risk bonds, the short-term performance of the other managers will be better. You might feel secure in your fiduciary duty, but your clients may be dissatisfied with their below average returns and move their money to your competitors.

If you buy the high-risk bonds while everyone else plays it safe, you will have better short-term returns and have a good chance of stealing the clients of your competitors. The result is that if *any* competitor starts buying high-risk bonds, *everyone* is going to be inclined to follow, even if they are not sanguine about the direction of the economy or the prospects for the bond issuers. Your opinions about the economy or possible future default rates on high-risk junk bonds are necessarily uncertain and may be wrong, but the high yields from the junk bonds are here today. In the mortgage industry, the lender to high-risk borrowers rejected by competitors picks up market share, gets her bonus check and moves on to another job before the borrowers default.

“Complacency is a state of mind that exists only in retrospective; it has to be shattered before being ascertained.”

~ Vladimir Nabokov

These “games” may explain why so many banks and money managers now take risks and employ leverage at levels considered insane not too many years ago. As we saw in the bubbly equity markets of the late 1990s, it is hard to sit still and do the right thing while everyone around you is getting rich. It makes investment sense to take on additional risk provided the market compensates you for that risk. Many market players recently, though,

assumed risk for competitive and organizational reasons, not rationality. Once you take the additional risk, there is always an incentive to continue to do so after others have chickened out, but this is a recipe for disaster. Like Buzz, eventually you will suffer the investment equivalent of catching your sleeve on the car door.

Unless you are really big and important, that is. In the financial services industry, when things have progressed to the point where bankruptcy is a clear possibility, the Federal Reserve and other regulators make a list of those “too big to fail” as opposed to those “too small to bail.” A major bank failure destroys investor confidence and negatively affects the economy, so the Federal Reserve and Treasury Department will try to prevent this at all costs. Large financial institutions presumably take comfort in this and feel free to take more risks than their smaller competitors who are less certain of a bailout. Assuming no obvious malfeasance, the worst that can happen to the big-bank executives is that they retire with a generous severance package. In this game of chicken, the central banks always lose; for political reasons, they will always give in to the too-aggressive or too-lax commercial bankers and save them from failure, causing the big banks to press the limits of rectitude and even sanity. This is not a recipe for long-term stability.

What is our recommendation? Ignore the market buzz and call us at (503) 419-3938 or go to www.sigmainvestment.com. Risk assessment is a vital part of our investment process. Games and dares may be fun, but your financial security is more important than entertainment, especially the kind of entertainment attractive to teenage juvenile delinquents and commercial bank CEOs.