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Who Shot the Sheriff?

Imagine a family putting up a sign bragging that because they have not experienced a burglary for several years, they are going to stop paying for an alarm system and cease locking the doors. Or a town announcing that since crime has been nonexistent, they are eliminating the position of sheriff to save costs. Would you expect their experience to change? Would you not want to at least consider that changing one factor might change others?

Baby boomers may remember a time when applying for a credit card was a time-consuming and stressful process. You filled out a financial information questionnaire, gave some work and salary references and then waited, several weeks later, for the verdict of the credit checking department of the card issuer. Some amongst us carry decades-old grudges against J.C. Penney or Sears as a result of a traumatic card issuance turn-down. Now fast forward to 2005-06. Financial companies bragged about issuing NINJA (No Income, No Job, no Asset) loans. How did we get from that "old" world to the new one?

Banking is a competitive business, and some smart MBA in the old days noticed that no matter how rigorous the credit checking process, the bank issuing credit cards still wrote off a relatively constant two to four percent of credit card debt. If the credit checks do not make much difference, why not just fire the credit checkers and run the card issuance business based upon a model assuming a two to four percent loss rate? The bank makes more money by saving the credit checking overhead, promotes the MBA and winds up on the cover picture of Forbes or Fortune. Jealous competitors follow suit.

Potential borrowers eventually perceived that nobody was checking their credit. Previously, card applicants policed themselves. Why take the trouble to apply if you will not receive a card? But when they see somebody worse off receiving a credit card, they will apply as well. People lose respect for the entire credit system if there is no consequence to defaulting on credit obligations. If you can easily receive a new and different card, why sweat about paying off the first one if they get in a bind? This is how lay-abouts, who never have been issued a W-2 form in their lives, wind up in bankruptcy with tens of thousands in credit debt.

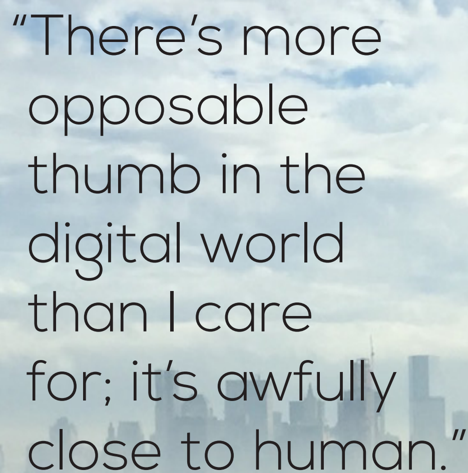
For decades, receiving and paying off a mortgage was a rite of middle class life. Willy Loman's wife in the last act of Arthur Miller's Death of a Salesman tells Willy's grave that she paid off their mortgage, their dream for so many years. The stigma of defaulting on a mortgage was severe in Loman's world; hence mortgage credit default statistics were quite low. Then speculative finance made its way into the mortgage market with no-credit-check loans. Wall Street investment banks sliced and carved mortgage-backed securities to manufacture yield in a low yield world. Credit ratings agencies blessed the new securities using historical statistics from the old credit-check world. Institutional investors and money funds, also comforted by historical statistics, piled into the higher yielding synthetic securities. Investors, comforted by historical lack of money fund defaults, piled into money funds. Borrowers, however, lacked respect for the system and rashly took on too much debt because of the absence of a sheriff, of anyone enforcing

credit standards. If the banks are not going to take matters seriously, why should they?

The unfolding of the global financial crisis in 2007 through early 2009 was the result of science envy in the financial services world. Science experiments produce replicable, constant results. Investment firms yearn to clothe their actions and theories in the respectable garb of the hard sciences. Ultimately, however, unlike the characteristics of sodium chloride in a beaker or the path of a comet in space, humans that affect financial markets are changeable, reacting to varying incentives or just plain acting irrational at times. Irrationality can happen at an alarming pace given the capacities of computers. When you change conditions (e.g. easing credit standards and lowering default stigma), people behave differently. When people cease to do analysis and just rely on models, the outcome can be unpredictable. A current example may be the popularity of certain fixed income exchange traded funds (ETFs) for which the underlying asset is relatively illiquid. Regulatory changes have led to significantly lower inventories on fixed income trading desks. Investors believing ETF prices will follow the underlying index may be disappointed if a crisis causes the markets of the underlying bonds to freeze.

The past few decades in the U.S. stock market have seen an increasing percentage of investor money going into index funds matching capitalization-weighted market benchmarks, based upon the observation that it is difficult for competing active managers to "beat the market." Index investors are therefore free rider beneficiaries of the work of stock analysts – they get the benefit of the "correctly" priced market, since any variance between price and value will be arbitraged away by active managers. But what happens if everyone indexes their investments? If nobody is paying attention at the individual company level, there could be big differences between price and value.

Sigma makes extensive use of index funds (and their non-managed, rules-based cousins) in client portfolios, and we do not believe we are anywhere near a point at which the market becomes inefficient because of too few active managers. Still, it is striking how the norm now is investors talking about indexes or sectors as opposed to individual companies. The lowly individual stock analyst and active manager, now in low repute, is the sheriff of the markets. With everyone obsessing about models and theories but paying little attention to the economic realities of corporate America, who is policing the town? Wise investors will focus on the impact of this changing behavior.



"There's more opposable thumb in the digital world than I care for; it's awfully close to human."

—Will Bonner, Mobs, Messiahs and Markets