Slaying Goliath

Federal Reserve Chairman Alan Greenspan delivered a rather dry and complex speech on December 5, 1996. The reaction, however, to such a seemingly mundane oration was unexpectedly immediate and powerful. It rattled Greenspan's confidence. He had innocuously uttered the now infamous phrase "irrational exuberance," and the mighty market roared its disapproval.

For several days, Bloomberg screens turned an angry red around the world. The "Maestro" was no David when he came face to face with Goliath. Greenspan cowered in the giant's presence, fear blinding him to the ogre's fragilities. Sadly, it was an opportunity lost because it is in the crucible of confronting giants—with everything on the line—that true grit makes the most difference in what the future will hold.

Many of us have had to square off with Goliaths in our own lives. The fact that you're still reading and I'm still writing is probably all that needs to be said.

Tragically for the victims of misguided policies, it would appear that appointed Federal Reserve Board chairpersons, with no skin in the monetary policy game, are exempt from the consequences of their own actions.

As speculation became more pervasive and the bubble expanded, Greenspan stood by passively, neither raising interest rates nor imposing the more subtle so-called macroprudential financial regulatory and oversight weapons in the Fed's arsenal. Instead, he dosed the bipolar Goliath with easy money whenever an intense mood swing threatened the market's upward trajectory, a crowd-reassuring maneuver he had first executed after the crash of 1987.

The easy-money elixir was administered again in 1998 after the Russian debt crisis and the collapse of Long-Term Capital Management, and then two years later on the eve of the millennium when the Fed was spooked by Y2K. By the dot-com bust in the early 2000s, Greenspan's deep-seated apprehensions about the economic aftershocks of a potentially significant market decline were well known and programmed into investors' expectations. Emboldened, they began to refer to the seemingly autonomic response as the "Greenspan put." He used the tactic again on January 3, 2001, even though evidence of impending recession was vague at best. The NASDAQ applauded, rising 14% on the news, its single biggest one-day advance ever. Lest we forget, central bankers are human, and (like most of us) they yearn for approbation. Money, a tangible and eminently fungible surrogate, tends to flood in over the transom only after they leave office.

Less than two years later, on October 15, 2002, Princeton professor Ben Bernanke gave his first speech just two months after being appointed by President George W. Bush to Greenspan's Federal Reserve Board. Bernanke's lecture came in the midst of the dot-com bust that his mentor, the chairman, had some hand in fomenting. Perplexingly, given Bernanke's nonexistent frontline experience, the topic was: "Asset-Price 'Bubbles' and Monetary Policy."[1]

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[1] Bernanke, Benjamin S. October 15, 2002, remarks before the New York Chapter of the National Association for Business Economics. New York, NY.
http://www.federalreserve.gov/Boarddocs/Speeches/2002/20021015/default.htm

Obfuscating the difficulty of the Fed pinpointing, let alone pricking, bubbles, faithful understudy Bernanke cited the earlier work of Yale financial economist Bob Shiller, who had testified at the Fed on December 3, 1996.[2] The presentation was published in 1998 by the *Journal of Portfolio Management*.[3] Shiller, Bernanke observed with the air of déjà vu that only hindsight affords, was among those warning of a bubble in stock prices. The Fed rookie staked his claim as a card-carrying member of the board with "a simple quantitative point." Referencing the *Journal* article, Bernanke noted Shiller had argued that at 750 on the broad-based S&P 500 index, the market was trading at three times its fundamental value. Shiller used a rudimentary but reliable dividend/price regression model.[4] The S&P continued to rise, peaking at double that number three years later.

Future Fed Chairman Bernanke declared:

> *I do not know, of course, where the stock market will go tomorrow, much less in the longer run (that's really my whole point*) [emphasis added]. But I suspect that Shiller's implicit estimate of the long-run value of the market was too pessimistic and that, in any case, an attempt to use this assessment to make monetary policy in early 1997 (presumably, a severe tightening would have been called for) might have done much more harm than good.[5]

Bernanke's assertion is absurd on its face. The surreal and revealing first point seems more suitable to weather forecasting where long-term forecasts are much more difficult than short-term ones, the antithesis of the way any rational investor thinks about equity market dynamics over the dimension of time. If we didn't have confidence that stocks would generally rise in the long run, why in the world would anyone invest a dime? The last point, a counterfactual assumption about the effect of tightening, was never tested by Bernanke. The signature policy of his eight-year tenure as Fed chairman was its polar opposite: unprecedented and unrestrained massive monetary easing.

We all know that Ben Bernanke opted out on the cusp of what just might be a very messy unwinding of the extraordinary near six-year-and-counting shower of Fed largesse when he retired[6] as Fed chairman in early 2014. Did he hear Goliath's thundering footsteps over the hill? But what about Bob Shiller after his errantly premature forecast? Beginning in 1997, did he slink into the shadows like Greenspan, humbled by the almighty market? You be the judge. If one studies Shiller's 1998 research (see footnote 3), it appears scholarly, courageous, without an economist's equivocation, and above all, rational in an era marked by extreme *ir*rationality.

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[2] Curiously, Shiller testified two days before Greenspan's "irrational exuberance" speech. Could it be that Greenspan was influenced by Shiller's analysis? It's also worth noting that Greenspan's choice of words later became the title of Shiller's compelling book *Irrational Exuberance*.

[3] Shiller, Robert, & Campbell, John. "Valuation Ratios and the Long-Run Stock Market Outlook," *The Journal of Portfolio Management,* Winter 1998. http://www.econ.yale.edu/~shiller/online/jpmalt.pdf

[4] Shiller's linear regressions of price changes in total returns on the valuation ratios suggested substantial declines in real stock prices, and real stock returns close to zero, over the next 10 years. The S&P 500 fell below 750 in the spring of 2009, twelve years later.

[5] Bernanke, op. cit.

[6] Bernanke's predecessor, Greenspan, served 19 years as Fed chairman. Bernanke served eight years in the same position.

Confronting the beast with everything on the line, Shiller went on to write the audaciously titled book *Irrational Exuberance,* which was published at the very peak of the market in early 2000. In yet another example of originality and verve, in 2005 he came back with a second edition, this one little changed from the first except for a new section highlighting the rampant speculation in real estate. It's obvious that Bob Shiller took a chapter out of Benjamin Graham's playbook:

> If you have formed a conclusion from the facts and if you know your judgment is sound, act on it—even though others may hesitate or differ. You are neither right nor wrong because the crowd agrees with you. You are right because your data and reasoning are right.[7]

Shiller was and is a David, as confirmed last winter by his take-no-prisoners Nobel Prize lecture and subsequent papers.

Shiller's objective was to be generally right, and at all costs to avoid being precisely wrong. As the *Journal* article makes clear, Shiller's standard was not the impossible exactitude of a point forecast. ***Recognizing a potential problem is a skill possessing intrinsic worth, for such problems are knowable only if one studies and understands the imprecise but ultimately undeniable connection between price and value—not the timing of its unraveling, which of course is unknowable with the same degree of accuracy.*** Shiller's added value in recognizing the potential problem was not negated by his inability to pinpoint precisely when it would come to a head. Bernanke's prognostications from his very first day as chairman revealed no such concessions to immutable realities.

Moving to the present, Janet Yellen, in a speech at the IMF as recently as July 2, made it clear that she embraces the party line: Monetary policy should not be used against incipient bubbles.

> In my remarks, I will argue that monetary policy faces significant limitations as a tool to promote financial stability: Its effects on financial vulnerabilities, such as excessive leverage and maturity transformation, are not well understood and are less direct than a regulatory or supervisory approach; in addition, efforts to promote financial stability through adjustments in interest rates would increase the volatility of inflation and employment. As a result, I believe a macroprudential approach to supervision and regulation needs to play the primary role.
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> … Taking all of these factors into consideration, I do not presently see a need for monetary policy to deviate from a primary focus on attaining price stability and maximum employment, in order to address financial stability concerns. That said, I do see pockets of increased risk-taking across the financial system, and an acceleration or broadening of these concerns could necessitate a more robust macroprudential approach. For example, corporate bond spreads, as well as indicators of expected volatility in some asset markets, have fallen to low levels, suggesting that some investors may underappreciate the potential for losses and volatility going forward. In addition, terms and conditions in the leveraged-loan market, which provides credit to

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[7] Graham, Benjamin, *The Intelligent Investor*, 4th edition (1973), Chapter 20, p. 287.

> lower-rated companies, have eased significantly, reportedly as a result of a "reach for yield" in the face of persistently low interest rates.[8]

Before bashing Ms. Yellen, we must respectfully acknowledge that she's the third runner in the Fed's easy-money, three-leg relay. She was passed the baton by Ben Bernanke, who took it from lead-off runner Alan Greenspan. The race is on: It is most unlikely that she will raise rates until she crosses the finish line, wherever she opts to draw it on the track. The reality is that no Fed chairman since Paul Volcker has had the courage of a David to lean against the wind with the full force of the Fed's power. Volcker's Goliath was the clear and present danger of double-digit inflation. Yellen's is a more subtle but perhaps no less insidious inflation in financial asset prices. In the end, it could be that Paul Volcker may have faced a less daunting enemy.

Even though a preemptive raising of rates is out of the question, Yellen is not powerless. In advocating a "robust macroprudential approach," which, for lay readers, means almost anything in the Fed's toolbox excluding raising rates, I believe raising stock margin requirements could send a conspicuous warning to retail investors about "increased risk-taking" and "'reach[ing] for yield' in the face of persistently low interest rates," the demon of the Fed's own design. Investors may not heed the Fed's admonition, but to do nothing constitutes willful negligence. Although margin requirements were frequently used as a tool after being authorized in 1934, the Fed has left them unchanged at 50% since 1974, in part because Greenspan repeatedly argued that such a move would be ineffective (see quote box below).

Alan Greenspan on the Impact of Margin Requirements (A Small Sample)

"There is no evidence to suggest margin requirements have an effect on the level of stock prices."

–Alan Greenspan, remarks to the Economic Club of New York, January 14, 2000

"Senator, as you comment quite correctly, the reason over the years that we have been reluctant to use the margin authority which we currently have is that all of the studies have suggested that the level of stock prices have nothing to do with margin requirements. That is, there is no evidence to suggest that changes in margin requirements up or down in years prior to 1974, when we did move them back and [forth], had any effect on prices."

–Alan Greenspan, confirmation hearing, Senate Banking Committee, January 26, 2000

"The problem that I have had with the issue of moving our margins is not a concern of what it would do to the marketplace, it's the evidence which suggests that it has very little impact on the price structure on the market or anything else."

–Alan Greenspan, Humphrey-Hawkins hearing, House Banking Committee, February 17, 2000

For the counterpoint *and so much more,* see the concise op-ed piece Bob Shiller wrote for the *Wall Street Journal* on *August 10, 2000* posted immediately following this commentary. For those who did

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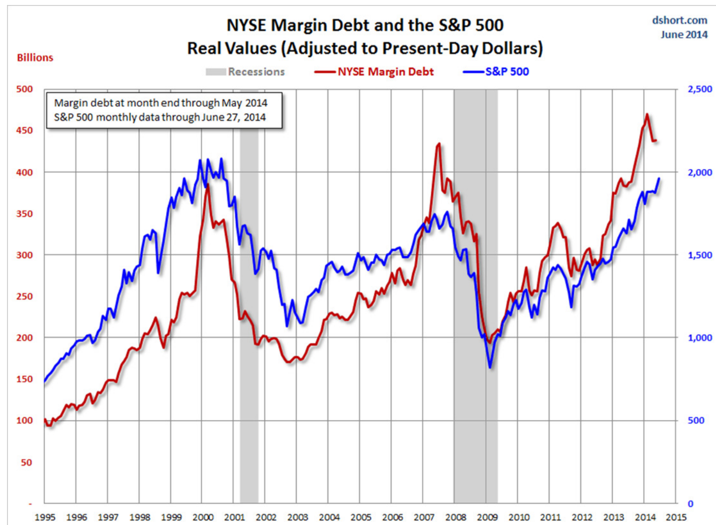
[8] Yellen, Janet. "Monetary Policy and Financial Stability." July 2, 2014 speech at the 2014 Michel Camdessus Central Banking Lecture, International Monetary Fund, Washington D.C.

not fare well when the euphoric dot-com mania came to its inevitable screeching halt, imagine how different things would have been if they had picked up the *Journal* that day, read Shiller's short op-ed piece, and acted decisively upon it. That's yesterday. Shiller's remarkably prescient and succinct essay is attached because I believe it is as relevant today as it was 14 years ago.

The accompanying graph, meanwhile, is included for effect. Many others could have been used, but few are as easy to grasp at a glance. Although there is a quickly discernible correlation between movements in the S&P 500 and NYSE margin account debit balances, correlation is not causation—i.e., expanding (or contracting) margin balances are merely coincidental, and not leading, indicators. Like the Shiller PE to which I often refer, the relative level of margin debt offers some indication about whether investors in general are in a risk-embracing or a risk-avoiding frame of mind. When they are aggressively, and most often unwittingly, following the crowd in chasing risky investments, the end, whenever it occurs, is not good. As noted above, we believe that recognizing a potential (and knowable) problem is a skill worth paying for (in option premiums and management fees), not the timing of its unraveling, which is far less knowable.



Prem Watsa, the iconoclastic CEO of the Toronto-based Fairfax Financial, a $35 billion insurance company, understands both the importance of identifying the problem and the pain of preparing for it well in advance of others. He offered the following candid insights in his 2013 letter to shareholders:

> In this environment, with zero interest rates and high debt levels prevailing in most developed countries, giving them limited flexibility to react to unintended consequences, we think it is prudent to have a very strong balance sheet with a large cash position and to be protected on the downside. When problems hit, only those with cash and very liquid assets can take advantage of them. While it is very painful and costly waiting, we think your (and our!) patience will be rewarded. We are reminded again of the warning from the distant past from our mentor, Ben Graham, which I have quoted before: "Only 1 in 100 survived the 1929–1932 debacle if one was not bearish in 1925." We continue to be early—and bearish!

Watsa is a David. His equity portfolio is 100% hedged with equity index swaps, and he also has a huge economic derivatives hedge that anticipates deflation will appear before inflation has its day. He argues that deflation would wreak havoc on most of his businesses. Since taking his stand in 2010, the book value of Fairfax has withered from $376 per share to $339 in the rising market, with the cost of hedges more than offsetting solid returns in his operating businesses. Lest Watsa be thought a Cassandra, Fairfax's book value was $150 in 2006 when he positioned the company's portfolio to benefit from tail risks that he saw as a problem—even though he had no idea when they might occur. When you tally things up, including those years when Fairfax badly lagged behind the indices, the company's book value has compounded at 21.3% since its founding in 1985. Seth Klarman (Baupost Group), about whom I've written extensively, has a similarly successful contrarian streak.

Like Bob Shiller, Prem Watsa, and Seth Klarman, we believe we know how to do battle with our Goliath. The key is to not do it on his terms. As emphasized in our 2013 annual report, we will surely lose if we fight conventionally. We must be cunning and creative in our decisions and actions. Off the field we must be open to suffering the ridicule of the majority; we must even be willing to look stupid. The story of David and Goliath is embedded in our language as a metaphor for improbable victory, which Malcolm Gladwell eloquently argues is a near universal misunderstanding of the biblical showdown. As one discovers in reading the latest of Gladwell's "improbable" books,[9] David's tactics and strategy actually stacked the odds decidedly *against* Goliath. David's victory was anything but improbable. Breaking convention, using speed and surprise, brandishing the sling and not the sword, David triumphed over the myth of power being solely a function of physical might or, in our field battle, the manic/depressive brute of a market that by dint of size and anonymity intimidates so many—even "The Maestro."

Our victory becomes much more probable if we first avoid loss by turning a deaf ear to the siren song of the amorphous crowd of which the market is a manifestation, and then figuratively using the leverage of the sling rather than the limited edge of the sword to seize the advantage. Ultimately, though, we simply want to have lots of liquidity when others are willing to pay a fortune in lost opportunity to take it off our hands.

One final observation: Notice that Ben Graham said (see Prem Watsa's blocked quote above) an investor had to be "bearish in ***1925***" to avoid the 1929–32 debacle. You may ask yourself, "Was that a misprint? Didn't he mean 1928 or early 1929? Why so early? Investors would have missed three full years of strong returns, wouldn't they?" Well, there are very good answers to those insightful questions … and like the keep-you-coming-back tactics of "House of Cards" on Netflix, we'll share our research and insights—including a plausible response to your rhetorical inquiries—in the 2014 *third-quarter* QCM Review. ☺

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July 2014
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[9] Gladwell, Malcolm (2013-10-01). *David and Goliath: Underdogs, Misfits, and the Art of Battling Giants.* Little, Brown and Company.

Margin Calls: Should the Fed Step In?

Yes, It may Avert Disaster

By Robert Shiller – August 10, 2000

The stock market is in its most dramatic boom ever. Despite last week's declines in tech stocks, the Standard & Poor's composite price-earnings ratio (real prices divided by the 120-month average of trailing real earnings) stands at 46. Until the present boom, the highest it had ever been (the data go back to 1871) was 33, in September 1929 -- the month before the crash. The dividend yield on the Standard & Poor's index stands at 1.1%, the lowest ever. The previous low was 2.6% in January 1973, just before the 1973-74 crash. Margin debt is soaring; it has increased 87% in the past year. In the midst of this record-breaking boom, the Federal Reserve Board remains silent about the speculative level of the market, neither commenting that the market is too high nor using its powers over margin requirements to dampen the markets. This inaction is unfortunate. Distortions of saving and investing behavior, driven by the public's illusion of stock-market wealth, are rampant, and the risks of economic dislocations and massive wealth redistribution are very serious if the market continues to soar and then crashes.

There are, of course, some who assert that the market is rationally high because of new technology that makes the outlook for future corporate profits very bright. But people have hailed "new eras" before -- in 1901, they cited the formation of giant corporations that would supposedly produce economics of scale; in 1929, it was electrification, chain stores and the spread of automobiles; in 1973, advancing productivity and technology. All of these "new eras" turned out not to be so revolutionary after all, and odds are today's market won't be any different.

The Fed used to change its margin requirements actively as a tool against speculative movements in the stock market, raising the requirement when the market got too hot and lowering it when things cooled. Between 1934 and 1974, the Fed changed this margin requirement 22 times, often with explicit statements that its aim was to restrain "speculation" in the stock market. But for 26 years the Fed has kept the margin requirement constant, at 50%.

The best policy for the Fed lies somewhere between these two extremes-between the hyperactive pre-1974 policy and the static policy since. The Fed should probably not attempt to fine-tune the level of the market as it once did. But it should occasionally make adjustments in margin requirements in times of major market misalignments, such as the speculative situation we see in the market today.

Why did the Fed abruptly abandon its active margin-requirement policy in 1974? An important factor was the influence of efficient-markets theory, the idea that markets always work extremely well. Eugene Fama's highly influential academic article "Efficient Capital Markets" appeared in 1970, and Burton Malkiel's efficient-markets book, "A Random Walk Down Wall Street," was first published in 1973. Ever since, the efficient markets theory has been a powerful influence. Most of our leaders who might feel like commenting on the level of the market have retreated from doing so, thinking such an action might be viewed as rash and irresponsible.

The efficient markets theory, unfortunately, is only a half-truth. The theory is right in the sense that it is indeed extremely hard to predict changes in the market over the next few months or a year. But the theory is wrong when it asserts that it is impossible for careful observers to detect that the market is a historic speculative bubble, as it has been in recent years.

Another factor making the policy of changing margin requirements look less attractive after 1974 was the rapid increase in sophistication of our financial markets since around that time, which created many new opportunities other than margin credit for investors to leverage their investments. Notably, the Chicago Board Options Exchange opened trading in stock options in 1973. Now individual investors can easily take speculative options positions in stocks without using margin credit. Yet this does not mean that the Fed should not take the limited action that raising margin requirements represents, for such an action will still be an important signal to the markets.
When the Fed actively managed margin requirements before 1974, it was following a fairly consistent policy of attempting to restrain speculation. Each of the 12 times margin requirements became more restrictive, stock prices had increased over the prior six months, often dramatically. In nine of the 10 times margin requirements were relaxed, stock prices had declined over the prior six months. Thus, it appears that the Fed was attempting to lean against prior stock market price changes. Moreover, there was some tendency for the Fed to keep margin requirements relatively high in times when the market price/earnings ratio was high, and relatively low when the P/E ratio was low.

At Times Erratic

Though the Fed's changes in the requirements were invariably controversial, and at times erratic, on balance the policy probably made some sense. If the Fed were to follow the same procedures today, given both very high price/earnings ratios and recent price increases, margin requirements would probably be over 90% now. The absence of such a reaction from the Fed board members today, the abandonment of their old concern about speculation, and the reluctance of national leaders to say anything about speculation in the market, must be part of the reason why the current boom is bigger than any before.

While the Fed should be very wary on principle of intervening in markets, increasing the margin requirement today would stand as a warning to investors not to leverage themselves up excessively and would work in the direction of cooling the market. Increasing margin requirements a little, to 60% say, and grand fathering existing margin credit so as not to induce an immediate crisis, would send a healthy caution signal. It is the most important step the Fed can take at this time of historic misvaluation in the stock market.

Mr. Shiller is a professor of economics at Yale's International Center for Finance and author of "Irrational Exuberance" (Princeton University Press, 2000)