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THE INVESTOR'S MIND: ANTICIPATING TRENDS THROUGH THE LENS OF HISTORY

NOVEMBER 2006

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- Similarities to 1987
- 1929 Anyone?
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HOT POTATO, HOT POTATO

The alarm went off during late May and early June of this year. In the months since the Dow has floated ever so gently toward the heavens, lulling investors back to sleep. Still, our readers are aware of the increasing systemic risk and are looking for accurate information to help them assess that risk. The only problem is that, because of recent changes to various aspects of the "money game," there is less clarity than ever before. Yet, the clustering of these changes could be a signal in and of itself that we are drawing nearer the end of this mother-of-all-manias. As has often been the case in historic times such as these, there appears to be a concerted effort to: manage our perceptions, buy some time, and transfer risk in what looks like an increasingly opaque, high-stakes game of hot potato. In this issue of The Investor's Mind, we'll string together this clustering of events, which began in the 3rd quarter of this year.

How Much is Too Much

In his August 21st issue of Crosscurrents, Alan Newman alerted us to the fact that the way in which program trading is calculated was changed on June 30th of this year. The NYSE press release found on their website states:

> "Program Trading as a percent of NYSE volume was formerly calculated as program buy volume + program sell volume as percent of NYSE volume. A more accurate calculation would be program shares bought, sold, and sold short as a percentage of NYSE shares bought, sold, and sold short." [1]

Newman points out that this adjustment immediately halved the percentage of NYSE volume attributable to program trading. Interestingly, all other volume statistics, such as daily and weekly volumes, remain as they have always been reported. Newman notes that program trading has grown from an average of 19 percent of volume, in 1999, to an average of 62 percent this year. When program trading reached a record high of 92% of volume, for the *week* of June 26th, the way in which it is reported was "coincidentally" changed. Even if the new calculation is more accurate, which is not at all conclusive, why was it changed now, and why was such a brief, and consequently vague, explanation given for the change?

Even more concerning is Dr. Bruce Jacobs' observation, in his book Capital Ideas and Market Realities, that program trading, through portfolio insurance products, contributed greatly to the Crash of '87. Jacobs states:

> "All insurance programs utilize a common rule: they buy as prices rise and sell as they fall. A large enough market move will thus trigger all insurers to trade simultaneously." [2]

As evidence, Dr. Jacobs notes the following regarding Black Monday in 1987.

> "From 9:30 – 9:40 a.m., program selling constituted 61 percent of NYSE volume, 63.4 percent from 1:10 to 1:20 p.m., and over 60 percent in two intervals from 1:30 to 2:00 p.m." [3]

MARGINING DETERIORATING ASSETS

So, on this fateful day in 1987, program trading reached 60 to 63 percent of NYSE volume at various points throughout the day. Now, when the same measures are used, we see that program trading has accounted for an *average of 62 percent* of NYSE volume *for the entire year thus far in 2006.*

If you'd like to read further on the fallacy of composition, which gave way in the Crash of 1987, we offer pages 62 through 66 of our research paper, "Riders on the Storm." If you want to stay apprised of the percentage of NYSE volume that program trading comprises, bookmark this page.

Margining Super-Leveraged Deteriorating Assets?

On October 15th of 2006, the Financial Times ran an article titled, "SEC to ease margin rules in cost-cut move." The article begins:

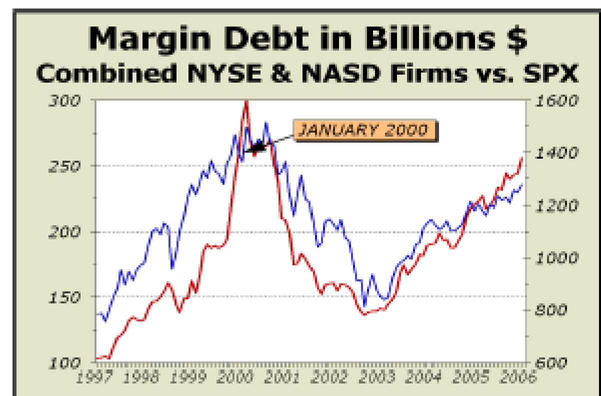
> "The US is set to relax margin rules in force since after the Wall Street crash of 1929 with the approval of a system that will cut securities trading costs and pave the way for 'multi- asset' trading across equities, options, and futures." [4]

For more explanation, consider this statement from SEC Commissioner Annette Nazareth's October 24th speech, which could allude to the SEC's intent.

> "In July of 2006 the Commission approved an expansion of the *prior portfolio* margining *pilot* to include listed, single stock *options* and securities *futures* contracts based on individual securities. The Commission is now considering margin rule amendments filed by the NYSE and the CBOE that *would further expand* the portfolio margining methodology to include *all* other equity products, *including* certain *OTC* ***derivatives.***" [5] (Emphasis mine)

So, since July of this year, options and futures, which are deteriorating (or wasting) assets, have been marginable within a "pilot" program. And, if the NYSE, the CBOE, and the SEC get their way, it looks like we will soon be able to margin *any deteriorating asset*, including unregulated derivatives. How is this a good idea?

I ask you, does this chart, produced by Alan Newman in his March 20th, 2006 edition of Crosscurrents, look like we need margin to expand more? And, now some want to lower margin requirements from 50 to 15 percent?



Robert Prechter's November Elliot Wave Theorist brings to the forefront the historical importance of this issue.

> "In case you haven't heard, the SEC is expected to re-write margin requirements that were established in reaction to the 1929 crash. Back then margins were as low as 10 percent. Leverage continued to run-up, and its unwinding contributed to its ensuing collapse. Since then – for over 70 years – margin requirements have been at 50 percent. Now the New York Stock Exchange has asked the SEC to let the Federal Reserve lower it back to 15 percent for institutional investors. When investors buy stock on margin, they put up *stock* as collateral. You can see what a house of cards this borrowing scheme can create." (Italics his) [6]

A DEBT WITHIN A DEBT WITHIN A DEBT...

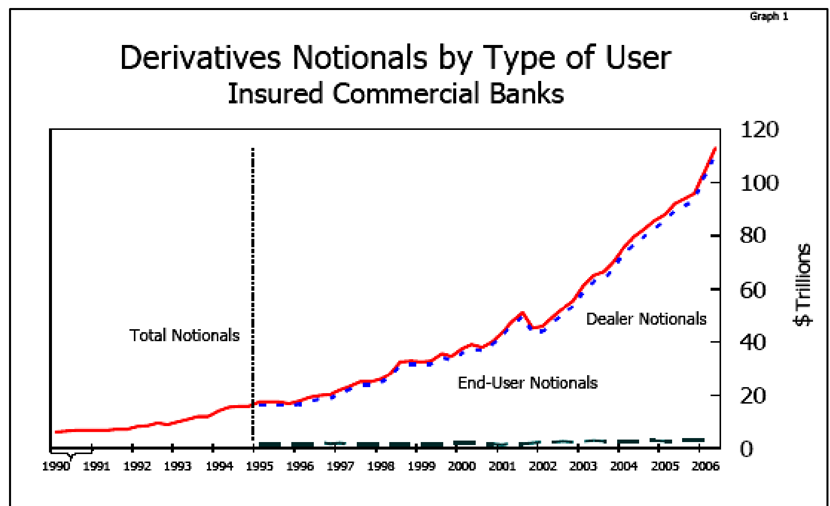
How unfortunate that the alteration (which I take as a contrary indicator) of such a long-standing rule will occur at a time when it will likely prove most destructive. Once again, Dr. Jacobs notes the illusory effects of margin upon markets.

> "After the crash, however, the SEC concluded: 'Low margins...contribute to the illusion of almost unlimited liquidity in the futures market. During a market break, however, that liquidity disappears at a rate geometrically larger than the liquidity in the lower leveraged stock market.'" [7]

So, if the margin requirements are lowered from 50 to 15 percent in the stock market, what affect will this have on liquidity? As we ponder, let's look at the largest, most leveraged, unregulated market in history...the derivatives market.

A Debt Within a Debt Within a Debt...

According to the International Monetary Fund's September 2006 Global Stability Report, at the close of 2005, the global derivatives market was valued at $284.8 trillion. According to the Office of the Comptroller of the Currency's 4th quarter OCC derivatives report, the total notional amount of derivatives for the US at the end of the 4th quarter of 2005 was $95.6 trillion. As we drill down below the surface, we find, as mentioned in our July newsletter, that over the last eight years, the credit derivatives market has grown from $55 billion to $5,472 billion, for an annual rate of 75 percent.



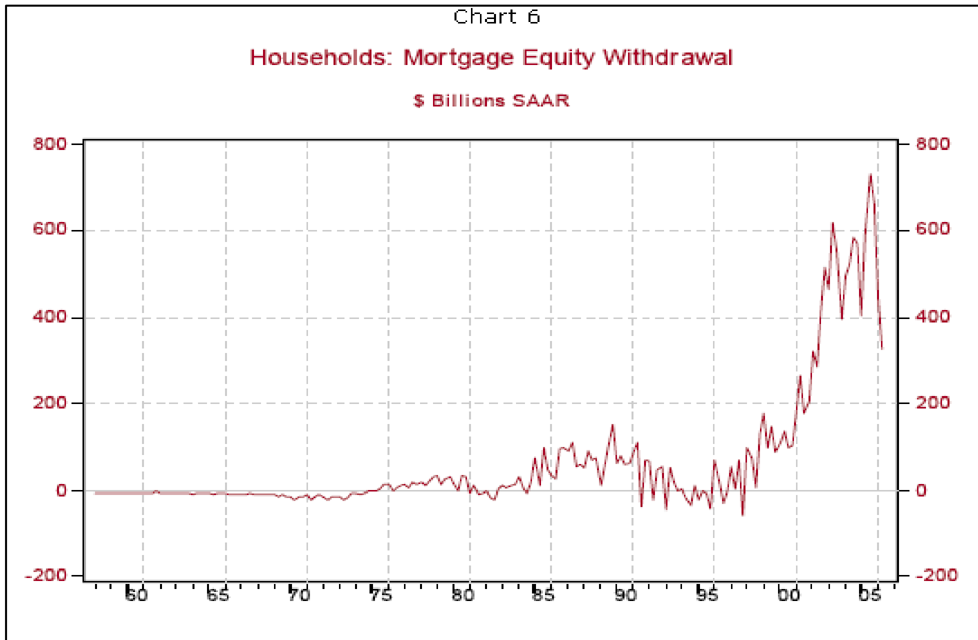
When we understand Credit Default Swaps (CDSs), where banks offload their balance sheet debts into Special Purpose Vehicles (see also Enron), which repackage these debts and sell them to yield-starved hogs so the bank can lend more money to your savings-short, debt-laden neighbor, we begin to understand why the credit derivatives market has experienced such stellar growth.

On November 6th of 2006, the Financial Times released an article titled, "Strategies to be changed after 'panic' over credit derivatives." The article states that a group of investment banks and hedge funds had been forced to "rapidly adjust their trading strategies amid reported 'panic selling' in the U.S. and European credit derivatives markets." Yet, the concern is not over what some would first think. To wit, the article notes:

> "Heavy selling has driven the cost of insuring debt against default in the market of credit default swaps to record *low* levels – signaling either that investors are extraordinarily optimistic about corporate debt [or government bailouts], or that prices are so distorted that they are no longer being paid for the risks they are taking on [or all of the above].
>
> The sharp price swings of recent days have confounded many investors, who had expected to see the cost of debt insurance rise this winter as part of a broader turn in the credit cycle." [8] (Emphasis mine)

A DEBT WITHIN A DEBT WITHIN A DEBT...

Of course, buyers of CDSs are buying protection, betting that the borrowers will default, spreads will widen, and volatility will increase.



When we look at this chart from Paul Kasriel, of Northern Trust, showing that mortgage equity withdrawal, which has largely supported consumer spending, has fallen off a cliff, the CDS buyer's position seems to make sense. The next chart, composed from the Fed's Q2 '06 Flow of Funds Report, shows a recent contraction in home mortgage debt, which supports this posit, as well.

So, the $400-billion-dollar question is, "Why did these areas experience a contraction in credit, which was not felt in the equities market?"

F.218 Home Mortgages - Seasonally Adjusted Annual Rates - in Billions						
Year	*2001*	*2003*	*2005.Q3*	*2005.Q4*	*2006.Q1*	*2006.Q2*
Net Borrowing	529.5	800.4	1323.3	1188.7	1002.8	859.2
Household Sector	484.6	854.5	1225.9	1169.6	955.5	819.6
Nonfinancial Corp.	2.1	1.8	6.6	7.6	8.4	7.5
Nonfarm Noncorp.	42.8	-55.8	90.7	11.5	38.8	32.1
Net Changes in Assets	529.5	800.4	1323.3	1188.7	1002.8	859.2

An Inside Moody's: Structured Finance, winter 2006 piece gives us a partial explanation, stating:

> "With credit spreads still well below historic norms, CDO market participants are using a new breed of synthetic CDO products that use *leverage* to boost investors returns. The new products, *leveraged* super senior transactions, constant proportion portfolio insurance (CPPI) and constant proportion debt obligation (CPDO) transactions, adjust *leverage* based on market-value-related triggers." [9]

In other words, the "brilliance" of the CPDO is that if the market moves against the writers (sellers), they can ratchet up their leverage and sell more CDSs to offset their losses.

A DEBT WITHIN A DEBT WITHIN A DEBT...

It's almost like the credit derivatives folks hired the same product design people that took us from 15 and 30 year fixed mortgages to adjustable rates, to interest-only adjustable rates, to 40-year, no-doc, interest-only, adjustable rate mortgages with 100 percent loan-to-value. In this instance, they seem to have taken credit card debt, mobile home loans, student loans, and mortgages, rolled them into Asset Backed Securities, then into Credit Default Obligations, and then into the new, Constant Proportion Debt Obligations – and, just in time for Christmas.

By the way, James Grant, of Grant's Interest Rate Observer, who is well known for his knowledge of debt instruments and markets, notes:

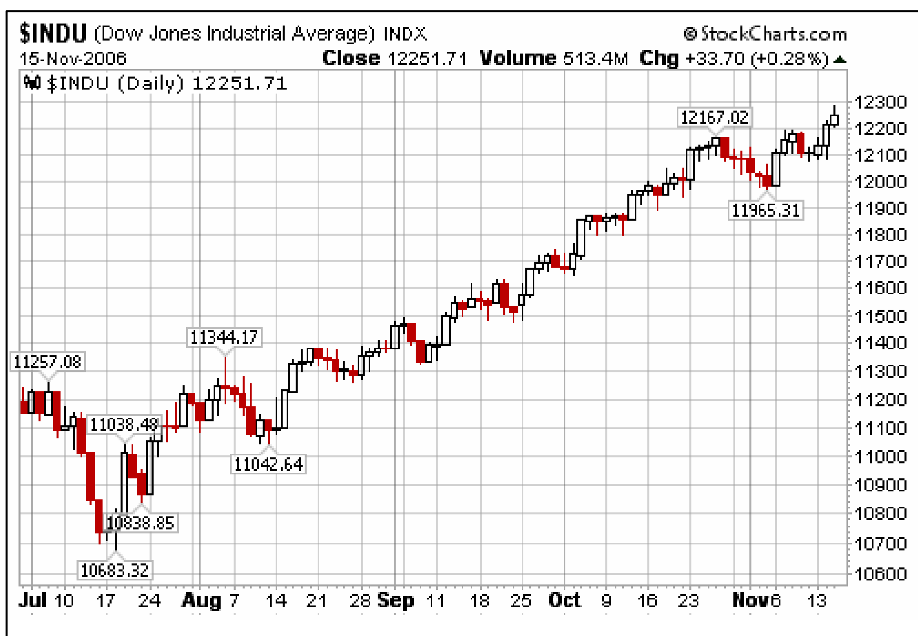
> "CPPI came to the fore as an equity gimmick a year before the 1987 stock-market crash. No coincidence as to the timing; portfolio insurance played a leading role in Black Monday." [10]

Speaking of the Enron and Worldcom fiascos, in his book Infectious Greed, Dr. Frank Partnoy alludes to a chain reaction, which resulted in massive losses in the debt markets.

> "In other words, banks were passing much of their credit risk to insurance companies and industrial corporations, even though banks were in a better position to monitor that risk. Moreover, an insurance company that bought credit risk from a bank might pass it along to another institution, which might pass it on to another, and so on. Because there were no disclosure requirements for credit default swaps, it was impossible to know who ultimately held the risk associated with a particular company's loans. But, it required a fantastic leap of faith to assume that the holder of the hot potato was in the best position to keep tabs on the borrower... *Thus, credit default swaps distorted global investment by leading parties to misprice credit risk.*" [11] (Italics mine)

Secretary Paulson to the Rescue

But, if all of this concerns you as much as it concerns us, let me alleviate your fears. Recently appointed Treasury Secretary Henry Paulson says that all is well and that there is nothing to worry about. For those of us who need reassurances, we need only look as far as the Dow to put all of our uncertainties to rest.



As a matter of fact, in a November 16th Fortune article titled, "Mr. Paulson goes to Washington," when Secretary Paulson was asked, "What is your greatest fear about the economy," he replied:

"I don't have a greatest fear about the economy. I feel better about the economy today than I did in when I was in the private sector in January. Then I was looking at a rate of growth that that was unsustainable and a housing market that was clearly growing at an unsustainable level. I was looking at some early signs of inflation, and I knew

SECRETARY PAULSON TO THE RESCUE

> that it was very important to get that under control if we were going to extend this business expansion.
>
> I heard the talk of a soft landing, and I remember joking with people and saying, 'Well, that will be one in a row.' Now we've got a healthy diverse economy. There are some very good signs that we're making the transition from an unsustainable level of growth to a sustainable level of growth." [12]

Henry Paulson was sworn to his post as Secretary of the Treasury on July 10th of this year. Since this date, the data continues to verify that: the housing bubble has indeed begun to deflate, mortgage equity withdrawal has been halved, wage growth remains stagnate, and credit derivative growth has continued its ballistic climb. Does it really look like the economy has transitioned to stability?

Though many may want to believe Secretary Paulson's words, his actions indicate that it is far more likely that he is trying to discharge his mandate to, "maintain investor confidence," created by Executive Order 12631.

As you are well aware, after the Crash of 1987, the boys at mission control realized that something had gone horribly wrong. But, as history has often shown, rather than honestly addressing the factors that contributed to the crash, we spent a great deal of money and effort to come up with the same answer we did after the Crash of 1929. The solution decided upon was, of course, "We need more intervention from the smart guys in government." Thus the Working Group, comprised of the Secretary of the Treasury, the Chairman of the Federal Reserve, the Chairman of the SEC, and the Chairman of the Commodity Futures Trading Commission, was born in March of 1988. As stated earlier, it's charged with the goals of:

> "…enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets *and maintaining investor confidence*." [13] (Italics mine)

And, according to an October 23rd Wall Street Journal article, it would appear that Paulson is intent on the group living up to its name. According to the article, prior to Henry Paulson's appointment, the Working Group had been meeting once a quarter. Now, they meet every six weeks. The same article notes,

> "Mr. Paulson is having the Working Group look at the *systemic risk* posed by hedge funds and *derivatives*, and the government's ability to respond to a financial *crisis*, officials said.
>
> He has ordered his chief of staff, Jim Wilkinson, to oversee the creation of a Treasury *command center* to track markets world-wide and serve as an operations base in a *crisis*." [14] (Italics mine)

Now, I know that this is just a coincidence and that a financial crisis is a "low probability event" and that Secretary Paulson is just being prudent. But, after looking at the Dow chart, it would seem to take more faith to believe that this is a coincidence than it would to believe that the Working Group is… at work. History bears witness to this possibility as well.

Over the last few weeks I have been working through Professor Quigley's tome, Tragedy and Hope, which he wrote in 1966. The parallels between Britain in the 1920s and the US in 2006 are noteworthy. Consider the following quotes from various publications and individuals of the British Empire at that time.

HITTING THE EXIT

In 1924, Sir Drummond Edward Fraser, Vice President of the Institute of Bankers, declared:

> "The Governor of the Bank of England must be an autocrat who dictates the terms upon which alone the Government can borrow money." [15]

On September 26th of 1921, The Financial Times wrote:

> "Half a dozen men at the top of the Big Five Banks could upset the whole fabric of government finance by refraining from renewing Treasury Bills." [16]

Or consider Reginald McKenna, Chancellor of the Exchequer in 1915 and 1916. In January of 1924, as Chairman of the Board of the Midland Bank, McKenna spoke the following words.

> "I am afraid the ordinary citizen will not like to be told that the banks can, and do, create money…And *they who control the credit of the nation* direct the policy of Governments and *hold in the hollow of their hands the destiny of the people*." [17] (Italics mine)

Could not these same words be spoken today? As we mull this over, let's consider the following comments from a Financial Times November 7th 2006, article.

> "The US Treasury and the Federal Reserve have met the 22 banks that make a market in US Treasury bonds, the hugely liquid market that sets the baseline for the rest of the global financial system, to look for ways to 'strengthen market integrity.'
>
> In an over-the-counter market conducted over the telephone, as the bond market once was, reputation is all-important…Richard Portes, a professor at the London Business School and an expert in the field, says that in the anonymity of electronic trading, the incentive to push the envelope, or to break the rules altogether, is much greater. If you are anonymous, you have no reputation to protect…Market abuse, according to Prof Portes and others, happens when a trader buys enough of an issue to restrict its supply and force up its price." [18]

When we combine information like that which is presented in this newsletter, with increasingly frequent sell signals from technical, fundamental, and sentiment indicators, concluding with a few thoughts about today's trading model tendencies, seems appropriate.

Hitting the Exit

As a student of the markets, I've learned an enormous amount about the world of money over the last few years. I find it particularly interesting that in discussions I've had with traders, and in reading great resources, like Michael Covel's Trend Following, of late, one word repeatedly comes up as the number one consideration in trading. Price. I would like to pose a question to us all – the academic, the investor, and the professional trader. In a game with the aforementioned increasing pricing distortions, and thus an increasing likelihood of a downward reappraisal of prices, is price really the only consideration?

From looking at different trading philosophies, it appears that the term "loss" is open to a great deal of interpretation, as well. For instance, some traders are stopped out at a 3 or 6 percent loss, while other traders place their stops at a 10 or 15 percent loss, and others use no stop losses at all. Some traders see stop losses as a discipline to keep them from racking up large drawdowns, while others see them as something that could whipsaw their strategy and force them to trade too often. Which is right?

HITTING THE EXIT

For example, Michael Covel, author of Trend Following, was able to interview managers whose long-term performance placed them at the top of all hedge fund managers. In listing the factors that have contributed to Dunn Capital's success, Covel states:

> "He cuts his losses." And that,
>
> "Dunn had losing years of 27.1 percent in 1976 and 32 percent in 1981 followed by multiyear gains of 500 percent and 300 percent, respectively. You must be able to accept drawdowns and understand that recovery is, by the nature of trends, around the corner." [19]

Dunn Capital Management's website states that from October of 1974 to September of 2006, they have had 10 drawdowns of more than 25 percent, with the average of those major drawdowns being 37 percent. Though Dunn has had an *average annual return of 19.22 percent* ***for 32 years***, Dunn's site warns prospective clients:

> "Clients should be prepared to endure similar or worse periods in the future. The inability (or unwillingness) to do so may very well result in un-recouped serious losses, without the opportunity for subsequent recovery." [20]

So, is Dunn Capital Management a good money manager? What does the size of their drawdowns or losses tell us about Dunn Capital's trading strategies?

The earlier piece on "panic selling" put forward the possibility, "that prices are so distorted that they [investors] are no longer being paid for the risks they are taking on." And, the Crash of '87, the demise of Long Term Capital Management, and many other episodes within the historical record prove that pricing distortions occur regularly. In each of these periods, many people's trading systems blew up. As such, we close this month's issue with three considerations.

First, we address the concept of career risk. As 2006 comes to a close, it appears that Jeremy Grantham's explanation of career risk, from page 46 of "Riders of the Storm," bears repeating.

> "The problem with bubbles breaking and going back to trend is that some do it quickly and some slowly. So at extremes you will always know what will happen but never when. Not knowing the timing creates critical career and business risk, which has molded the business of investing. If you are smarter than most and want to take no career risk, then anticipate other players and be quicker and slicker in execution or as Keynes said, 'beat them on the draw.' Refusing on value principles to buy in a bubble will, in contrast, look dangerously eccentric and when your timing is wrong, which is inevitable sooner or later, you will, in Keynes's words, 'not receive much mercy.' Today, the challenge is not getting the big bets right, it's arriving back at trend with the same clients you left with." [21]

In the two years preceding the year 2000, GMO watched their asset base decline by 33 percent. While the investors who stayed with GMO were rewarded in 2000 to 2002, it is almost certain that GMO didn't "arrive back at trend with the same clients" with which they left. To paraphrase Morningstar's 2002 International Fund Manager of the Year, Jean-Marie Eveillard, "I would rather lose half my clients, than half my clients' money." [22] At times it becomes impossible to maintain a contrarian stance and please the emotional impulses of the herd. But, when examining the impact of price on a trading system, career risk is always a consideration.

HITTING THE EXIT

The second consideration is what some have termed "the crowded door" problem. As more and more money is placed into derivatives, as faster and faster computers and networks allow faster trade executions, and as the number of traders continues to rapidly expand, the financial marketplace becomes crowded. This atmosphere feeds herd-like tendencies, extreme optimism and overconfidence, which can be found in every mania.

In many ways, for those who realize the inherent danger of the current environment and who continue to trade long, it is like prospecting for gold on Mount St. Helen in 1980. Imagine, if you will, that the job can be quite lucrative, so the small groups of prospectors are well paid. They have all the equipment they need to find and extract the gold, to make money, and all the equipment they need to measure the seismic tremors and ground deformation, to leave before disaster strikes. And, as so often happens, more prospectors come. And, more still. And still, more. But, when May 18th arrives, all air traffic in the area is cancelled, and the two-lane road is log-jammed with hours of exiting traffic. My point is, why not diversify strategies, and allow for one that exits ***prior*** to the fire alarm being pulled? Though the last few years have led many to believe that credit always expands and will always sustains the markets, history has shown that being early certainly has advantages that merit consideration.

Finally, one of the most important issues for us to consider today is the same one we discussed last month – ethics. Or, more specifically, is intervention ethical? The very terms, "providing liquidity" or "too big to fail," make it clear that market intervention is a widely accepted practice, and that, though it favors certain groups of investors in the markets over others, collectively, we see no ethical issue with it. If the public understands that the Working Group is intervening in various financial markets today, and because of this intervention, certain individuals have advantages that others do not, will most individuals say that this is wrong, or that this is just part of their job of "maintaining investor confidence?" If we consider it "wrong," how do we convince investors, as a group, that our moral evaluation is "right?"

In conclusion, since none of us have lived through the series of events that awaits us, none of us can ever be completely mentally and emotionally prepared. When prices are reappraised and the forces of gravity take over, no one will ask whether it was a fundamental, technical, or sentiment indicator that warned us. Much like the way we see the Great Depression today, future generations will see this as an historic time. Very, very few will ask for a manager's numbers. They will only want to know one thing. Were you prepared, and did you survive the change.

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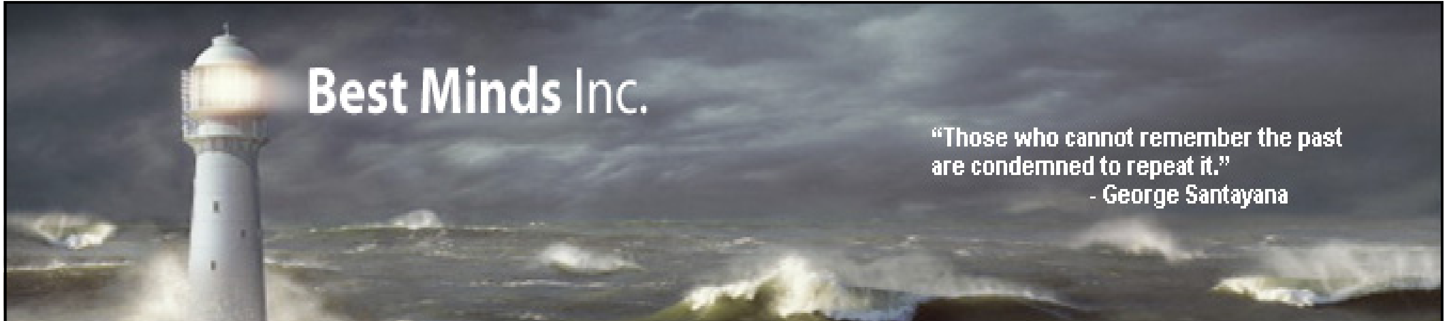

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