origins of the crash - the great bubble & its undoing

By Roger Lowenstein
Penguin Press
New York 270 pages

review rating

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Roger Lowenstein is a finance journalist of considerable repute, and has written two best-sellers: Buffett: The Making of an American Capitalist and When Genius Failed - reviewed this web site. He writes with considerable authority through depth of understanding, and it is revealed in footnote 14 to chapter one that his father is Louis Lowenstein, author of Sense and Nonsense in Corporate Finance – a 1991 text which I still hold and value. Louis is, or was, a Professor of Finance and Law at Columbia University.

The title, to this reviewer's mind, is something of a misnomer, as during the 2000/02 period the US market did not actually "crash" through a precipitous short term fall (days/months) as it did in 1929 and 1987 – each of which events was called a crash. In October and November of 1929 stocks fell by half, and, as he points out in his Epilogue, the S & P took two years to record the same loss. However, over time, the net effect was the same, and in some ways it was worse in 2000/02 for, as he explains by reference to Galbraith, in 1929 it was the wealthy and well-to-do that suffered, whereas in 2000 half of Americans owned shares, and hence the pain was indisputably more widespread.

Terminology aside, this is a first rate work of some importance, and implicitly aspires to fill the same gap as was brilliantly filled by John Kenneth Galbraith in The Great Crash. That is no small aspiration, and Lowenstein can make a solid claim to such mantel with this book – which, like Galbraith's, is reasonably short, punchy and merciless in observation. In many respects, it is most worrying for the Australian investor, for one cannot help but think that if this can happen to the world's largest and (per popular acclaim and empirical analysis) most efficient equity market, then why not just stay at home? In many respects, the picture painted here of the late 1990's in the US has parallels to Australia in the run up to 1987. Clearly, the corporate cowboy is not dead.

Setting the scene

Before getting into the appalling corporate shenanigans of 1998 and later, Lowenstein sets the scene by reference to origins of the current culture. There is an interesting history, starting with The New Deal of the 30's, with its emphasis on disclosure; we travel through the period of hostile takeovers (70's and 80's), and are reminded of the colour brought by the likes of T. Boone Pickens; thence to Michael Milken and how LBO (leveraged buy-out) mania took hold – the precursor to dot-com mania.

Into the 1990's, and he theorises, with considerable force, why executive compensation went galloping along the options path. Executives had no downside, only up-side, and an up-side locked into stock prices, which became the all-pervasive consideration of corporate life. The arguments propounded in favour of options were superficially appealing and were peddled by well respected management gurus of the day; but in the end – as Lowenstein later explains – they planted the seeds for much corporate fraud.

Market participants and Wall Street in general (eg, Abbey Joseph Cohen) receive their just desserts, as he explains the recovery post 1987 and the enthusiasm for "buying the dips" in the next decade. Then came the exponential growth of 401k plans, which originated from an "administrative accident" in 1980. From US$400 billion in 1990, these funds doubled by 1995 and just kept going, fuelled by novice investors who "began to think of managing their retirement portfolio as a basic part of being a literate American, like knowing how to buy insurance or select a mortgage."

This attraction of the stock market and the significance of corporate finance, gave birth to another phenomenon in the US, that we have not seen to the same degree: the rise to prominence of the CEO (chief executive officer). Several factors fed this phenomenon, not least of which that in numerous US corporations, the CEO combined the chairman role, and even today (post Sarbanes-Oxley) there is still no requirement for an independent chairman. At p 225, Lowenstein contends that the British system, which relies upon an independent chair, is better.

In chapter three (Enlightenment Gets out of Hand) he further analyses the incredible ascent of executive remuneration, which fed upon itself. Interlocking boards of directors scratched each other's backs, and the escalatory spiral of pay for performance "was transmuted into a gilded sinecure." Each new award had to leap-frog its precursor. "By 1997, CEO's on average were taking home 326 times what a factory worker was making (compared to a ratio of 10 or 15 to 1 in Europe)." This egregious activity, and its impact on corporate earnings, was recognised and denounced by sections of the investment community, and Lowenstein provides a revealing, if disquieting, recount of the US system of democracy in relation to the debate over expensing of options.

In 1993 the US FASB recommended a rule to deduct the cost of options from reported earnings, and this was supported by Arthur Levitt, then head of the SEC. What followed was an extraordinary tale of political lobbying and string pulling, which effectively buried this proposal for years, as by late in 1994 Levitt reluctantly advised the accounting board to back down. Darker forces had prevailed.

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The super-rich became wealthier, and Paul Krugman's is cited for the observation that it was remarkable how little of the boom wealth did trickle down the socio-economic scales.

In chapters four and five (Numbers Game, and Doormen at Noon) there is a worrying expose of the deficiencies in US accounting, and once again Levitt appears to have been cut at the pass in trying to improve standards – this time with consulting work undertaken by auditing firms. It appears as though Levitt could see how this would all end, but he never enjoyed the political support required to confront Wall Street and implement change – that was left for the 2000/02 collapses (see below) and Sarbanes-Oxley.

Bubble takes off

From chapter six onwards, the latter half of the book deals with internet (eg, dot-com) mania, and all that it spurned. This is a thorough exposition, for Lowenstein has the gift of looking through the numerous examples of absurd IPO's and bizarre investment activity, and actually explaining how the psychology of the moment was a force which pervaded almost everything. This was a new religion, and if you were not part of it, you were "old economy" and passé. And, so, if you were a lumbering old energy company, with massive low yielding fixed assets (plant and pipelines etc) you had to transmogrify into a new generation company – as indeed was portrayed by Enron. In 2000 Ken Lay (CEO) asserted that Enron could become the world's "preferred platform" for e-commerce: p 144.

All the leading characters appear to be covered: stock analysts (or, at least, those persons who were thought to be analysts!); the banks who supported the SPV (special purpose vehicle) schemes; the audit firms who turned a blind eye or, worse, actually cooked up the accounting obfuscation and deceit; the regulators (eg, Spitzer); the executives (from those who were indicted for fraud, to those who suffered considerable loss of reputation through hubris); and finally the lawyers – who appear to have a good deal to answer for. Lowenstein deals with all this in a measured, objective but fearlessly critical way. One wonders if a book such as this could be published under Australian defamation laws, for there is damning praise a plenty. Technology dot-com promoters and "incubators" are mostly portrayed as opportunistic entrepreneurs, who simply exploited a market bubble to ride with each new wave. They mostly went down with their investors, when pass-the-parcel dried up and "profit" was eventually appreciated as being different to blue sky "growth". However, the telecom executives were of a different ilk, for they spent most of their time concealing what they actually were (utilities), and masqueraded to be something exotically futuristic, so as to achieve hefty stock multiples, which enabled them to sell to those who bought into the masquerade – which included just about everyone. There is detailed coverage of Enron, and a good outline of Global Crossing.

The financial press takes a real beating from Lowenstein, for there is citation after citation of the plaudits awarded to Enron and other disaster stories, right up to their demise. The annual Fortune survey voted Enron the most innovative company six years in a row. The Journal of Applied Corporate Finance applauded Enron's "genius" for transforming energy markets – and so on, including praise from the Economist. For Enron, Global Crossing and others, Lowenstein gets to the heart of the deceit and the character of the individuals who played leading roles. This is quality journalism, supported by voluminous footnotes with supporting sources and references.

In the onset of bankruptcy, there is a good explanation of how the accounting tricks unravelled, and how executives eventually got caught. The book was published this year and appears to cut-off around February 2004. However, there is ample recitation of the prosecutions and inquiries of wrong-doing. Importantly, there is a brief explanation of the thrust of the Sarbanes-Oxley Act, and how it came into being. He ends with some apprehension as to whether this is sufficient to stop a re-play.

In the end, as we know (so far) 2000/02 on Wall Street, did not cause a depression, as occurred in the 30's. However, the wrongdoing and the pain inflicted will cause scars for many years, and perhaps has not yet fully played-out. This is a seminal work covering a most troubling period in global markets – which investors cannot just ignore and put down to economic forces and market exuberance. Barefaced dishonesty, corporate fraud and concealment were rife – and on an unimaginable dollar scale. Greed was not "good", and investors were treated with disdain by the broking community (ie, analysts) and by corporate executives.

Post reading observations: Australia is not a bad place to be in 2004: mostly respectable boards; CEO's monitored by (reasonably) independent chairmen; pay often too generous, but not completely out of kilter – but the financial press? What this book tells the investor, is, like all the wise old sages say: stick to real earnings (however unfashionable) and discount hype (however fashionable) – and try to assess the integrity of corporate executives. At times, each of these homilies is not so easy to follow or invoke.

MARTIN EARP
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