Insights into the
Global Financial Crisis
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Foreword

At a recent meeting of the Research Foundation of CFA Institute Board of Trustees, one trustee insightfully commented that a successful Research Foundation book should explore the outer edges of ideas, contributing unique knowledge and perspectives while also being relevant to investment practitioners.¹ This book, a collection of wisdom from today’s deepest thinkers on markets and the economy, does just that. The authors deliberately push the boundaries of investment ideas in a way that will cause readers to think differently, yet more constructively, about the world around them.

Although the imminent collapse of financial markets has passed for now, the many consequences of the crisis lie in its wake. Whether the crisis presents a mere flesh wound or something much more severe remains to be seen. At its core, the massive debt owed by developed nations portends weakness in economic growth. An extraordinary moral hazard also remains for financial markets and looms large over the macro economy. These and other pressing economic issues provide the impetus for this book and are confronted with a wide-eyed and clear-headed approach.

We humans possess an unwavering desire for progress, mostly built on innovative tools, ideas, and techniques. Consider how we continually adopt innovations and ideas. My PDA (personal digital assistant) once gave me a competitive edge, but such devices rapidly became ubiquitous and are no longer a nicety but a necessity. This compulsion to adapt, or otherwise fall behind the curve, is firmly entrenched in our human condition. It cannot, and indeed should not, be dispensed with. Further to this point, the wide adoption of ideas and technology mostly produces highly desirable and beneficial societal outcomes. But alas, there is always an exception. In the realm of financial markets, the massive penetration of an idea and/or technology can and has led to dire outcomes. Here, as we are all keenly aware, herding ends badly.

Markets unambiguously work best when we all form our own, independent views. But in forming views, investors, like all people, instinctively fall back on what others are doing around them. This is so because, in grappling with an uncertain future, we figure our view is no better than our neighbors’. Keynes once argued that in the realm of investments, calculating the future is futile, saying that uncertainty in investments has “no scientific basis on which to form any calculable probability whatever” (p. 214).² But progress, indeed human survival, has long relied on anticipating the future. The notion of better solutions found by groupthink actually works

¹Thanks to Frank Reilly, CFA, for this succinct insight.
well for some applications (for example, when a young farmer sees the more-seasoned farmers planting their crops in the spring and follows suit in the hope for a bountiful summer harvest) but fails miserably when applied to uncertain financial markets.

In the pursuit of progress, we are thus seemingly hardwired for both groupthink and innovation. Unfortunately, the interaction of these two—innovation and collective delusion—in the realm of financial markets all too frequently feeds a wave that builds until it can do so no longer, inexorably crashing upon the shore with systemic impact.

Contrary to groupthink, this book presents a collection of solidly independent viewpoints expressed through many years of practical, relevant experience. We, and our authors, would have it no other way. The articles presented in this book deal head on with the crucial issues confronting our global economy—those of today and those on the horizon. We hope you will find a careful read as rewarding and fun as it has been for us to put the book together.

Finally, we offer our sincere appreciation to the many distinguished authors presented in this book; all have been so very gracious and generous in contributing their time and talent. We are honored by their commitment to the profession. We also thank the CFA Institute Centre for Financial Market Integrity for its partnership in this important endeavor. We are pleased to present these diverse voices of wisdom speaking on the most critical financial matters of our time. With clarity comes progress.

Rodney N. Sullivan, CFA
Head, Publications
CFA Institute
A democracy can only exist until the voters discover that they can vote themselves money.

—Popular saying, origin unknown

Private vices will always thrive. Greed, envy, lust, pride, and my favorite, sloth (I can’t help thinking of the two-toed, upside-down mammal) will continue to drive human action as they always have.

Some argue that greed is good. They have a point. Greed certainly makes the engine of the economy hum. Like Adam Smith, I would rather get my dinner from a merchant acting in his own interest than from one pretending to act in mine. Through the processes described by Smith, private vices are channeled in such a way as to produce public benefits. This transformation is well known to students of economics and is seeping through to the general public. But it does not work perfectly all the time.

Private vices are restrained by what Smith called “enlightened self-interest.” If you are too greedy, you stand a chance of losing money. Regarding lust, as Danny O’Keefe sang in “Goodtime Charlie’s Got the Blues”: “you play around, you lose your wife; you play too long, you lose your life.”

But private vices with no corresponding public benefits are encouraged when individuals are protected—or think they are protected—from any negative consequences that might arise while getting to keep the rewards. This chain of cause and

1The origin of this quote (sometimes wrongly attributed to Benjamin Franklin and often worded “... vote themselves largess from the public treasury”) is hotly debated. It is usually attributed to the Scottish history professor Alexander Fraser Tytler (1747–1813), known as Lord Woodhouselee, but Daniel Oliver, a political writer who chaired the Federal Trade Commission during the Reagan administration, argues that Tytler never said it (see http://spectator.org/archives/2009/03/09/accuracy-is-desirable, accessed on 6 October 2009).

2The equation of private vices with public benefits, under the right conditions, is usually associated with Adam Smith’s (1723–1790) masterpiece The Wealth of Nations (1776), but the English philosopher Bernard Mandeville (1670–1733) made the connection—and used the phrase—considerably earlier.

3Or it is being re-learned—now that market economics is fashionable once more in the academy, after a half century (roughly 1930–1980) when it was not. We will see if this fashion survives the current financial crisis, which has been blamed by many commentators—almost certainly wrongly—on an excess of freedom in markets.
effect is what economists call “moral hazard,” a phrase that has been growing in familiarity since global capital markets began to collapse in 2007 and as the collapse intensified in 2008 and the early part of 2009. The decline in market values, amounting to 57 percent from peak to trough as measured by the daily closing value of the S&P 500 Index of U.S. equity prices, revealed that once-proud financial institutions and other corporations had experienced losses on a mammoth scale. These losses were so large, and the institutions so interconnected through complex contracts and financial instruments, that the whole global financial system was at the point of collapse. Parts of the system actually stopped functioning: For a few weeks in September and October 2008, many healthy businesses could not obtain short-term credit at any price. Although financial conditions have improved dramatically since then, substantial long-term economic challenges remain.

What caused the losses? The chief source was about as unlikely as could be imagined: leveraged speculation on home mortgages. The details of the mortgage bubble and its bursting are explained in many other articles in this book, so I will not repeat them here. But what caused financial institutions, including investment banks, commercial banks, hedge funds, mutual funds, and other organizations supposedly run by well-informed profit seekers, to speculate so recklessly on home mortgages?

There has been broad agreement among observers that moral hazard caused the speculation and hence the crash. As with any moral hazard, the source of the hazard is guarantees or insurance, but explicit government guarantees of particular securities or companies is not what I am primarily concerned with. Instead, I believe that a larger problem exists: Governments around the world, and in particular the U.S. government (the one I am most familiar with), have tried to use macroeconomic policy to achieve a riskless society. These governments are doing nothing Machiavellian or sinister; they are just trying to please the voters who chose them so as to avoid being turned out of office.

But as the physicist Edwin Goldwasser said at a recent memorial service for his childhood friend, the great investment thinker Peter Bernstein, a riskless society is “unattainable and infinitely expensive.”7 We are now paying that expense. The

4This essay focuses on the United States and refers to data (such as returns on the S&P 500) that are U.S.-centric. However, much of what is discussed here applies likewise to non-U.S. economies.
5Although most of the articles in this book distinguish between the central government and the central bank (which are operationally separate in the United States), for brevity, I refer to both institutions combined as “government.”
6Investors are not blameless; at times they appear capable of believing almost anything, and of pricing assets accordingly. But other authors in this book focus on aspects of investor behavior in fostering the bubble and crash; my focus is the role of government.
7Edwin L. (Ned) Goldwasser was one of the founders of the National Accelerator Laboratory (Fermilab), Batavia, Illinois, and was its deputy director from 1967 to 1978. The quote is from his speech at a celebratory memorial for Peter L. Bernstein (1919–2009) in New York City on 15 September 2009.
mystery is how ordinary people—the electoral constituencies of democracies around the world—came to believe that their governments could protect them from all macroeconomic risk.

**The Great Moderation—Or Was It?**

One clue in solving the mystery is the perception, correct or otherwise, that increasingly wise management of either the monetary or the fiscal aspect of government (or both) has dampened the business cycle. The so-called Great Moderation is a sharp decrease in the amplitude, as measured, of the business cycle between the pre–World War II era in the United States (say, 1787–1941) and the postwar period (1942–2009). This discontinuity is easily visible in Figure 1 of Ray Dalio’s article later in this book, and its existence as a real phenomenon is an article of faith among many economists.

But the distinguished economist Christina Romer, who now serves the Obama administration as chair of the Council of Economic Advisers, has argued that the Great Moderation is a data error (see Romer 1986). Specifically, she points out that prewar macroeconomic data (including GNP, industrial production, and unemployment—all key indicators of the business cycle) were collected and analyzed using an outdated methodology that we would not and do not use today. The postwar data, in contrast, were collected using a more modern and accurate method. Most economists would have stopped here and said that the two periods could not be fairly compared, but the fiendishly clever Romer, realizing that she could not go back and collect the old data again using modern methods, re-examined the new, postwar data using the old method! The result, which you have probably guessed by now, is that if one uses the same method to study both periods, the Great Moderation disappears. The amplitude of the business cycle, Romer finds, is the same as it always has been.

**The Great Depression**

The role of government in the economy, moreover, has grown and grown over time, mostly through the application of monetary and fiscal policy. In the Great Depression era, monetary policy received short shrift (with some arguing that the Depression was worsened by the Federal Reserve pursuing a policy of crippling tight money in the face of collapsing real economic activity); instead, fiscal policy, specifically deficit spending, was aggressively used by policymakers, acting under the influence of John Maynard Keynes, to stimulate the economy. Because government intervention in the economy is not a controlled experiment (with one patient receiving a placebo while the other gets the real medicine), we will never know whether the Depression was relieved or prolonged by the Keynesian policies of the

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8See Friedman and Schwartz (1963).
Hoover and then the Roosevelt administrations. Although economists are still fighting over this question three-quarters of a century after the fact, a consensus is emerging among economic historians (but not policymakers) that World War II, not the New Deal, brought us out of the Depression and that many New Deal policies worsened the Depression instead of hastening its end. I happen to believe that the relief programs were justified—that providing relief is what a government is for—but that most of the other programs were not.

What we do know is that the Great Depression did end, after an excruciatingly painful decade, and the economy grew to new heights of prosperity, never again to sink to Depression-era levels of unproductivity. Many people, and apparently most policymakers, believe that the government’s role in ending the Great Depression was net positive. At any rate, the prudential principle suggests that if another depression is threatened, one had better take action similar to what may (or may not) have ended the previous one. The analogy to medication is close: If the doctor does not know whether the medication cured the disease last time but does know that the patient got better, the doctor had better administer the medication the next time the disease strikes. There is, of course, a downside: The medication might be hurting the patient (but not so much as to kill him or even keep him from fully recovering). But absent a controlled experiment, one has no way of knowing the potential harmful consequences.9

If the government could drag the economy out of the Great Depression, then it can fix almost any economic problem—or so many people believe. But what happens when the economic crisis that threatens has almost nothing in common with the Great Depression? Let’s look at the next major dislocation faced by the United States and other advanced economies, the Great Inflation of the 1970s.

The Great Inflation

Government always has an incentive to inflate because inflation enables the government to pay back debts in dollars (or whatever the relevant currency is) that are cheaper, in terms of goods and services, than the dollars that were borrowed.

Some private actors also benefit from inflation. In particular, private (nongovernment) debtors benefit from unexpected inflation. Like the government, these debtors can borrow in rich dollars and pay back with cheap ones. That the inflation is unexpected causes the inflation not to be impounded in interest rates. One can typically pull this switcheroo only once in a lifetime because lenders remember that

9 Economists use *counterfactuals* in an attempt to imitate the controlled experiments used by laboratory scientists. That is, they model a past situation and then vary one historical fact to see what the model says the result would have been. An extensive body of literature describes, supports, and criticizes this method. It suffices to say that counterfactuals are not really the methodological equivalents of controlled laboratory experiments in the physical sciences, and we do not really know what would have happened during the Great Depression if different policies had been pursued.