

Manias, Panics and Walls of Worry

C15.0042
Lesson 12
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Manias

Mania (n)
excessive or unreasonable enthusiasm

Merriam-Webster Dictionary

***“Without due recognition of crowd-thinking
(which often seems crowd madness) our
theories of economies leave much to be
desired.”***

Bernard Baruch, 1932

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Manias

“ . . . moral epidemics which have been excited, sometimes by one cause and sometimes by another, and to show how easily the masses have been led astray, and how gregarious men are, even in their infatuations and crimes.”

“Memoirs of Extraordinary Popular Delusions and the Madness of Crowds,” Mackay, 1841

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Tulip Mania – Holland 1635

How Much Is a Tulip Worth?

Conrad Gesner is credited with bringing the first tulip bulbs from Constantinople in 1558 to Holland and Germany, where they became much sought after among the rich and well-to-do.

How Much Is A Tullip Worth, Mark Hirschey, AIMR, July/August 1968

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Tulip Mania – Holland 1635

By 1634, the rage for possessing tulips had spread to the middle classes of Dutch society. Merchants and shopkeepers began to vie with one another in the preposterous prices being charged for simple tulip bulbs. Men were known to have paid a fortune for a single bulb—not with the idea of reselling at a profit but simply for private admiration. Later investors began to accumulate tulip bulbs for resale and trading.

How Much Is A Tulip Worth, Mark Hirschey, AIMR, July/August 1968

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Tulip Mania – Holland 1635

In 1635 individual tulip bulbs traded at an implied price of \$17,430 to \$76,085 (1968 US dollars).

Tulip notaries and clerks were appointed to record transactions; intricate public laws and regulations were developed to control tulip trade.

How Much Is A Tulip Worth, Mark Hirschey, AIMR, July/August 1968

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Tulip Mania – Holland 1635

Then in the early autumn of 1636 some prudent investors began to liquidate their tulip holdings. Tulip prices began to weaken, slowly at first and then more rapidly.

Within six weeks tulip prices had crashed by 90 percent or more.

How Much Is A Tullip Worth, Mark Hirschey, AIMR, July/August 1968

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Conglomerates – US 1968-70

“The Best and the Brightest”

The business schools are creating a generation of managers who believe that effective management techniques transcend industrial categories. . . . [Diversification] liberates management’s thinking about expansion: Uncommitted to any individual industry, management can swing capital quickly into any business field that looks profitable enough.

Business Week, 1968

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Conglomerates – US 1968-70

Now maybe this is one of those situations in which the solution lies in integrating the problem and raising it to a higher level. . . . There's no reason why you can't take 200 square miles some place that has the natural resources, which means primarily water—and even the water problem can be solved separately if it has to be—and create an ideal city with solutions for all these urban problems before it's even built.

Roy Ash, CEO of Litton Industries, told Fortune how his company was thinking of addressing the problem—with a “de novo city”

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Conglomerates – US 1968-70

According to a study by economists David J. Ravenscraft and F. M. Schere, anyone investing \$1,000 in Teledyne Inc. and a dozen other budding ‘free form’ conglomerates in 1965 did 3.6 times better than the Standard & Poor's 400 industrials index by their banner year of 1968. But by 1974, these investors' gains had been more than wiped out. Those who bought at the 1968 peak fared even worse: They lost 56% of their investment by 1974, though the market was up 10%.

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LBOs – US 1989

Mr. Milken Becomes “Highly Confident”

In the spring of 1989 a PaineWebber analyst who had just upgraded McDonald’s from “attractive” to “buy” was recommending the stock to a portfolio manager who remarked, “It’s a fine company, but what has it done for shareholders?”

The PM was thinking in terms of the new metric that governed the stock market in the late 1980s.

“New Economy: Yes, New Metrics: No” Kerschner, March 12, 2000

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LBOs – US 1989

One did not buy a stock just because it was cheap in comparison to its growth rate, but rather because it was likely to benefit from a “strategic action” such as a leveraged buyout, an acquisition by another company or a corporate raider, or a major restructuring (which might involve such moves as selling businesses, leveraging the balance sheet and buying back shares).

“New Economy: Yes, New Metrics: No” Kerschner, March 12, 2000

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LBOs – US 1989

• **July 7:** *Sterling Drug gains 5¼ on takeover rumors; Southland jumps 7¼ on heavy volume as the Thompson family, which controlled the company, agreed to take it private.*

• **July 8:** *“Portfolio managers want out of the high-technology stocks and into companies with undervalued assets, high cash flow and restructuring possibilities,” a trader said.*

• **July 9:** *Takeover speculation swirled around Gillette again. Texaco gained ½ on heavy volume as a group led by Australian investor Robert Holmes a Court raised its stake to 7.4% from 6.4%.*

• **July 13:** *An analyst commented that there was a decreased supply of stock available because of numerous company stock buybacks and the elimination of many large-capitalization stocks from the market through leveraged buyouts and mergers.*

The Wall Street Journal’s “Abreast of the Market” columns July 1987

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LBOs – US 1989

• **July 28:** *American Express rose 1½ on heavy volume as investors anticipated announcement of a major share buyback. Harcourt Brace rose 1¼ as it paid a special dividend as part of a restructuring plan. Other publishers moved up on anticipation Robert Maxwell might make a bid. Graco jumped 6¼ after saying it would buy back as much as 26% of its shares.*

• **July 30:** *A trader commented, “When portfolio managers are sitting there with cash and the market is going to new highs, it brings them into the market.” Another trader said that stock investors seem to have forgotten about what is happening with the dollar, bonds or commodities and have focused inwardly on the market . . . They’re paying attention to such announcements as stock buybacks, earnings reports and forecasts, and special situations such as restructurings and mergers.*

• **July 31:** *A trader noted that the market “is feeding on itself. The momentum of the last few days is bringing people into this market.”*

The Wall Street Journal’s “Abreast of the Market” columns July 1987

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LBOs – US 1989

Deals were being done not because they made economic and financial sense, but because investors, bankers and others were hungry for fees.

Inappropriate companies were being taken private in leveraged transactions—one-product companies, companies subject to commodity price swings, technology companies with volatile markets and high R&D spending, among others.

Investors were overpaying, and finessing the problem by issuing new instruments such as “zero-coupon” debentures and PIK or “payment in kind” securities. As Forstmann explained, PIK’s were “based on the notion that when a borrower is too broke to pay his interest in cash, he can ‘pay’ by issuing an additional note, which he also can’t afford to service. This is the intellectual equivalent of doubling your money by folding it in half.”

Risks were raised even further by the fact that we were late in the business cycle.

*Theodore J. Forstmann, The Wall Street Journal
“Leveraged to the Hilt—Violating Our Rules of Prudence.” 1989*

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LBOs – US 1989

Forstmann was completely correct, but also a year early. The Wall Street deal machine continued to operate through most of 1989, applying the new metric of private market value to one company after another.

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LBOs – US 1989

“UAL Friday” and the End of Private Market Value

In the fall of 1989 Wall Street was abuzz with rumors of airline deals. When the proposed LBO of United Airlines failed to get financing from bankers, the DJIA dropped 191 points (6.9%) on Friday, the 13th of October. Many “deal stocks” collapsed, badly hurting those who were speculating in them with borrowed funds. UAL fell 70% from its LBO-mania peak over the next year.

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Dot Com – 1998-2000

Because Jim Clark wanted a big boat!

1987 / LBOs

Earnings don't matter

—The new metric is private market value

Interest Rates don't matter

—Strong profits will cover interest expense

Stock-bond relationship doesn't matter

—Bonds cannot compete with LBO returns

The Fed is raising rates to cool a hot economy

—LBOs show no signs of slowing

A new way of trading will prevent heavy stock losses

—Portfolio insurance

Debt levels are high

—Corporate sector debt

Dot Coms

—The new metric is price to sales etc.

—New Economy cos are not debt dependent

—Bonds cannot compete with Net returns

—The Internet shows no signs of slowing

—Day trading over the Internet

—Consumer margin debt

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Dot Com – 1998-2000

In the minds of many investors, . . . because they are prized for their potential earnings power five or ten years from now, these “new new industrials” cannot be valued by traditional metrics such as price-to-earnings multiples. Instead, many investors have turned to new metrics, such as price-to-sales (or its equivalent, market cap-to-revenue), revenues per customer, gross profit per customer etc.

“New Economy: Yes, New Metrics: No” Kerschner, March 12, 2000

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Dot Com – 1998-2000

What will trigger the beginning of the end of the current new metrics era remains unclear. The actual events that triggered the beginning of the end of previous new metrics eras were relatively minor. And, as was the case with prior manias, the complete demise of the current new metrics era may well take a few years. But, the initial corrective stage will likely be quite damaging just the same.

“New Economy: Yes, New Metrics: No” Kerschner, March 12, 2000

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Dot Com – 1998-2000

After rising 64% for the year through March 10, the “new new industrials” have given back half their gains over the last three weeks.

Even after recent price declines, valuations of “new new industrials” still look excessive by traditional metrics. Further price declines seem likely. . . The “new new industrials” could fall by almost another 50%.

New Metrics Falter” Kerschner, March 30, 2000

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