Who's to Blame When the Market Drops? Analysis Often Misses Mark

By Seth A. Klarman

Oct 23, 1989

WHENEVER the stock market goes through one of its crashes or mini crashes, the search for an explanation immediately begins. The finger pointing has an overwhelming tendency to miss the mark, however. Partly, this is because the wrong questions are being asked and answered. People seeking answers to why the market plunged usually emphasize the immediate events that precipitated a selling panic, when in fact these events are but minor symptoms of much more severe underlying problems.

Many experts have identified program trading as a major cause of the stock market crash two years ago and of last Friday's panic as well. While it is true that derivative securities such as options and futures divert capital away from real investments, program trading gets an undeserved bad rap in the aftermath of market crashes. Program trading is very straightforward arbitrage technique whereby professionals take advantage of discrepancies between actual stock prices and stock futures prices.

If, for example, stock futures (contracts to buy or sell stocks for future delivery) dip materially below stock prices, astute program traders would buy stock futures and sell the underlying stocks, locking in a return. During market crashes, people view this behavior as putting downward pressure on stock prices, contributing to the selling panic. Who Drove Futures Down? In reality, the parties that have immediately caused the panic are those that have driven futures down below stock prices. The program traders are actually serving to narrow the gap between stocks and futures by buying the undervalued and selling the relatively overvalued.

Without program traders, it would surely be only a short time before other investors saw that they themselves could benefit from discrepancies between futures prices and stock prices; then they would become de facto program traders, deciding to trade before prices changed any further. Program traders cause futures market activity to be reflected in stock prices. They are not the underlying cause of stock price declines.

There are a number of underlying causes for stock market panics, not the least of which is market overvaluation. Indeed, today's financial markets have a distinctly upward bias. Anyone can buy a stock, but only shareholders and short sellers can sell. Short sellers are actually a major force in limiting market overvaluation, even with numerous rules that constrain them. Wall Street, on the other hand, tends to encourage market overvaluation through excessive optimism: analysts have been known to write 50 buy recommendations for every sell, for example. Today, Wall Street is optimistic not only from habit or because optimism is good for business; with billions of dollars of firms' capital tied up in merchant banking transactions and bridge loans, Wall Street is optimistic out of necessity.

Domino Effect

Given the upward bias, it is not surprising that a sharp burst of futures selling, translated by program traders into stock selling, causes a panicked response. Numerous other factors have concerned some investors for years. The widespread availability of credit and the resultant bad loans have resulted in overbuilt real estate markets, declining real estate prices and banking-system losses. The proliferation of LBOs, whereby companies routinely incur more debt than their annual cash flow can service, has resulted in a precarious level of debt in hundreds of sizable companies.

During this trend toward greater leverage, Wall Street readily abandoned corporate earnings as a valuation tool in understanding LBOs, looking instead at IBITDA (earnings before interest, taxes, depreciation and amortization). This analytical tool supposes that equipment does not wear out and buildings don't need to be maintained, even though nobody thinks this is really the case. Wall Street simply has chosen to ignore the financial reality, because it has become immensely profitable in the short run to do so. Source of

Overvaluation

Newly issued junk bonds, which have burgeoned from virtually nothing to a $200 billion market in the past decade, are a major contributor to market overvaluation. The market for these non-recourse securities is based entirely on flawed or highly questionable assumptions, and has never been tested in an economic downturn.

Last week, without any economic downturn, this market melted down; activity was actually subdued, but you could not find buyers for most junk bonds within shouting distance of the quoted price levels. Somehow, most junk-bond mutual funds reported that their share values had hardly declined last week, and some actually reported price appreciation. This is amazing given the enormous discount they would surely have to take to sell even a small part of their holdings.

Junk bonds and leveraged buyouts also have a pernicious effect in that they are a factor in determining the price of corporate assets at the margin. Even though only a limited number of companies are purchased in LBOs or issue junk bonds, the "private market value" of all companies is calculated with the leveraged buyer in mind. If LBOs fail and junk bonds cannot be issued, the private market value of all companies will be greatly diminished.

Funds Are Forced to Sell

The nature of open-end mutual funds has the potential to greatly exacerbate any stock or junk-bond market crash. People have come to treat their mutual fund investments like bank accounts; they expect immediate liquidity in their funds' shares despite significant illiquidity in the underlying assets. Open-end mutual fund selling sparked by shareholder redemptions was a major cause of the 508-point market decline on Oct. 19, 1987. The completely illiquid nature of the junk-bond market today raises the specter of a possible bloodbath, were we to experience major shareholder redemptions of junk bond mutual funds.

When markets crash, people ask why prices dropped so far so fast. No one, though, asks why the stock market recovered 1,000 points from the last crash so quickly, when so many of the underlying causes still exist. Most large institutional investors treat client funds very differently than their own money, feeling a compulsion to be fully invested at all times regardless of the level of prices. Since they are evaluated on their results every calendar quarter, they cannot afford to drop behind the pack. As a result, people own things for clients that they would not touch for themselves. When the decline starts, they act like anyone who has no particular confidence in own: they sell.

When the finger-pointing goes on after the next crash, it will be awfully easy to miss the boat again. The average investor has become what is known in the trade as a "yield pig," trading safety of capital for incremental yield, resulting in boom for junk bonds and Australian bonds. They also create a market for the mutual funds that invest in government securities while dabbling in options trading to offer illusory double digit returns from 8% government bonds.

Many investors have blindly accepted pronouncements from Wall Street of things they intuitively knew made little sense, such as the unrealistic valuation tool of EBITDA, or the recessionless forecasts that accompany most junk bond prospectuses. Stocks cannot forever outperform the returns of the underlying businesses, as they have for most of the 1980s.

People have for much of this decade let greed overcome fear as their principal financial emotion. When the net fear-inspired panic occurs, investors' finger-pointing will almost certainly be aimed outward, while a good part of the blame should instead be directed inward.