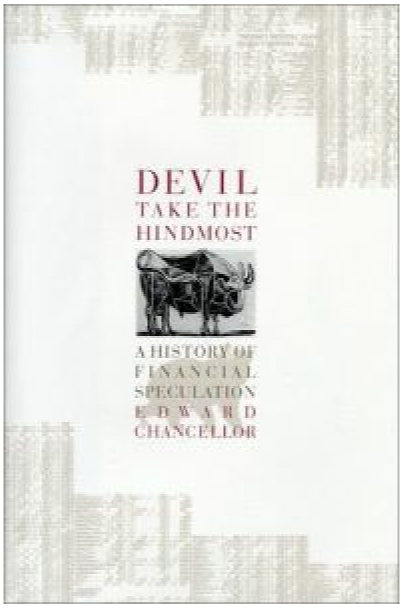

Book Devil Take the Hindmost

A History of Financial Speculation

Edward Chancellor
FSG, 1999

Recommendation

This is a thoroughly engaging book about the world of financial speculation. Edward Chancellor discusses the origins of financial markets from the time of the Roman Empire through the modern Internet bubble. The book offers great insights about stock exchanges, outbreaks of speculation mania, and the fraud and greed that accompany any human endeavor. He presents in-depth reviews of many well-known "speculative manias" and several of the lesser-known ones. *BooksInShort* recommends this book to anyone who wants a thoughtful treatment of a subject that touches all our lives.

Take-Aways

- Speculation and gambling have similar psychological origins.
- A bubble is a period of time during which speculation is no longer rationally based.
- The Tulip mania of the 1630s is memorable as a speculative bubble because it closely parallels stock market manias.
- The Technology bubble of the 1990s is dangerously similar to the technology bubble of the 1920s.
- The speculative paradigm is based upon crowd psychology, particularly when investors' rationality is weakened.
- When the rewards of the bubble are great enough, speculators will accept a high level of cognitive dissonance.
- We have moved from distrusting speculation to embracing it as necessary and valuable.
- There is no such thing as an efficient market.
- Be very suspicious of analysts who claim that the market is fundamentally different this time.
- The "Greater Fool Theory" is that tomorrow there will be someone foolish enough to purchase the shares you bought today for an even higher price.

Summary

Speculation and Human Nature

What is speculation? Some modern, intense examples include Internet companies, day trading, and the 1990s rise of the U.S. economy. Adam Smith believed the speculator "...is defined by his readiness to pursue short-term opportunities." John Maynard Keynes called speculation "...the activity of forecasting the psychology of the market." Fred Schwed said, "speculation is an effort...to turn a little money into a lot. Investment is an effort...to prevent a lot of money becoming little."

> “Speculative manias commonly occur at the inception of a new industry or technology when people overestimate the potential gains and too much capital is attracted to new ventures.”

Many people view speculation as a form of gambling, believing that, the "psychologies of speculation and gambling are almost indistinguishable: both are dangerously addictive habits that appeal to fortune." During investment bubbles, speculators follow a herd mentality that rejects traditional risk analysis. In fact, it can be argued that investors today are pursing the Internet the same way investors in the past pursued land, gold, cars, and railroads.

Rome, The Tulip Mania and The Modern Age of Speculation

The earliest speculation goes back to ancient Rome. Roman law allowed free transfer of property, money lending, currency transfers, and payments via bankers’ drafts. In these ancient days before developers, legal entities existed that received contracts to do jobs for the state, such as building temples. Stockholders owned these intermediaries. Their shares were traded publicly and fluctuated in value.

> “The most striking similarity between the 1920s and 1990s bull markets is the notion that traditional measures of stock valuation had become obsolete.”

The growth of speculation from Roman times through the later middle ages was limited. Medieval Europe viewed the pursuit of profit as morally corrupt. But, in the fourteenth century several Italian city-states began issuing government securities. These securities were actively traded in Venice, Florence, Pisa, Verona, and Genoa. By the late 1590s, Amsterdam and the Dutch Republic were the leading centers of speculation. In 1602, the United East India Company received the first joint-stock company government charter, enabling it to exploit "commercial opportunities in the Americas." As the company grew, speculation increased. The company issued futures, options, and ducation shares. Ducation shares permitted less wealthy people to speculate because they were valued at a tenth of the price of ordinary shares. These modern day equivalents of derivatives permitted holders to leverage their investments, thus increasing the prospect for speculative gain.

> “The success of the American economy in the 1990s has largely been the product of speculative funds flowing into the stock market.”

The first great speculative bubble, the "Tulip Mania," occurred in the Dutch Republic during the 1630s. At the time, no one knew that a virus that attacked the bulbs caused colors and pattern variations. Thus an inherent chance existed in bulb cultivation. Because of this element of chance, cultivators recorded the histories of their bulbs on separate sheets and assigned each bulb an individual number. Prices soared in Paris and Northern France. As word of these rising prices spread, new growers entered the market. As the market changed, "private negotiations between individuals gave way to informal meetings...where traders and speculators could trade in convivial surroundings." Personal credit notes were issued to cover the purchase price of the bulbs. Contracts to purchase bulbs were resold before the bulbs were dug up and delivered. From late 1636 through early 1637, speculators raced to buy and sell contracts. On February 3, 1637, the tulip market crashed.

> “The new paradigm ideology is simply a product of the bull market. As long as investors maintain their faith in a new era and ignore dissonant information, then stocks will continue to rise.”

The tulip mania’s significance was the resemblance between the tulip and stock markets. The higher-priced variegated bulbs resembled blue chip stocks, while the lower-priced breeder bulbs resembled penny stocks. Tulip mania was stimulated by a sharp increase in the price for rarer bulbs. That encouraged new players to enter the market. Share prices climbed sharply. This pattern repeated with railway stocks in the 1840s and motorcars in the 1920s. Some argue that Internet stocks follow the same pattern established during the tulip mania. In general, speculative manias tend to occur, "at the inception of a new industry or technology." This is "when people over-estimate the potential new gains and too much capital is attracted to new venture."

Schemes and Manias

The emergence of the stock market in London in the late 1690s was a significant event for speculation. Before that, no regular market existed for trading shares. As early as 1692, a periodical emerged that listed stock market prices. Gambling was also common. Writers at that time recognized the similarities between gambling and speculating in the stock market. When Edmund Halley produced the first mortality tables, the issue of statistical probability - in the form of life insurance - was added to the speculative mix.

> “The theory of the ’rational bubble’ appears to be nothing more than an elaborate restatement of the ’greater fool’ investment strategy whereby the speculator knowingly buys shares above their intrinsic value hoping that a ’greater fool’ will pay more for them later.”

With the stock market came fraud. The term stock jobbing described the act of "blowing up shares above their true value while simultaneously running down a company’s real prospects." The 1697 economic crisis was blamed on stock jobbing. Seventy percent of all English and Scottish companies failed. In a pattern that would repeat throughout history, investor euphoria was inflated, but only promoters and stock operators profited.

> “The term stock-jobbing - synonymous with speculation as well as the trade in shares - also described the act of blowing up shares above their true value while simultaneously running down a company’s real prospects.”

The South Sea scheme was the next great bubble. A successful investment scheme called "Mississippi" was launched in France. It transferred French government debt to an investment company in exchange for trade rights in French Louisiana. Speculators bought shares in the investment company. Based on "Mississippi," the English launched their own scheme speculating upon future profits from investments made in far away lands. In the South Sea scheme, English government debt was converted to stock in a company that took over government debt. In exchange, the company received interest payments and a trade monopoly with South American’s Spanish colonies. Both schemes substituted paper currency for gold and created a great inflationary spiral for their respective shares.

> “No one is satisfied with even exorbitant gains, but everyone thirsts for more, and all this is founded upon a machine of paper credit supported only by imagination.”

In the South Sea scheme, the government debt consisted of various annuities that could only be converted voluntarily by their owners. The South Sea Company had to offer an incentive to the owners to convert their shares. Essentially, it raised the value of its shares to make the conversion more attractive to annuity holders. All parties involved had a vested interest in maintaining an inflated share price. Share prices started to rise when the plan was announced to Parliament on January 21, 1720. Shares began at 128 pounds each, and reached more than 300 pounds by March, while Parliament debated the conversion scheme. Everyone benefited from the continued rise in the share price. However, share price quickly outgrew the venture’s ability to earn enough profit to justify it.

> “The term emerging market was first coined in 1986 by a bureaucrat at the International Finance Corporation, a World Bank affiliate. It sounded like a more appealing place in which to invest than the third world or a less developed country.”

In addition, the share prices were manipulated through loans to shareholders. The loans were made from the sale of shares. Thus the company itself fueled the demand for the stock by using stock proceeds to lend money to allow new investors to purchase stock at higher prices. Eventually, this combination of investor irrationality and company greed created an unstable condition. Just before the stock collapsed, the company offered a 50 percent dividend to encourage subscription sales. By September, the stock price fell from 800 pounds to less than 200 pounds in four weeks. The bubble collapsed as fast as it developed.

The Railway Bubble

A similar bubble occurred with the introduction of a new technology - the railway - in the 1840s. The speculative mania for railways began in 1842 when Prince Albert persuaded Queen Victoria to make her first train trip. Writers proclaimed the revolutionary effect railways would have on human civilization. By 1845, sixteen new railway schemes had been proposed. More than fifty new companies registered. Six months later, a parliamentary report identified more than 20,000 stock subscribers. As with earlier schemes, many subscribers purchased subscriptions beyond their means. They hoped to sell them before they took possession of their shares. Writers denounced this speculative behavior. For example, a piece in The Economist said, "The market value depends, not on the opinion as to the ultimate success of the undertaking, but rather how far circumstances will tend to sustain or increase public appetite for speculation." By 1848, the bubble burst.

The Crash of 1929

The greatest stock bubble of modern times was the crash of 1929. In the 1920s, people in the United States believed that the country had entered "a new era of limitless prosperity." Writers discussed the "new economics" of the times. The Federal Reserve System, established in 1913, was "the remedy to the whole problem of booms, slumps, and panics." Scientific corporate management techniques began to replace older, more tired management methods. A well-educated, trained speculative class, particularly alumni from Harvard School of Business Administration, improved productivity in ways never seen before in business. The United States' citizenry believed the county had entered "a new era without depressions".

> "The boom in leveraged buyouts became the driving force behind the bull market of the mid-1980s."

The belief in a new era of business was buoyed by income tax, capital gain tax, and corporate tax rate reductions. These reductions freed up more money for wealthy individuals to invest and retain. Consumer buying power did not appreciate the same way. Two events increased the mania and fueled the bull market among consumers. First, brokerage houses expanded their offices and boosted their sales. Second, margin loans became a popular source of personal credit. This does not explain the full effect of the eventual crash. By 1929, more than two million Americans were stock market players, but millions more were interested. John Kenneth Galbraith wrote, "...the striking thing about the stock market speculation of 1929 was not the massiveness of the participation. Rather, it was the way it became central to the culture."

> "Speculative euphoria is often a symptom of hubris."

A crowd is intellectually inferior to an individual. A crowd's intellectual shortcomings show in its ability to filter and manipulate information to fit its beliefs. Psychologists call this "cognitive dissonance." However, people tolerate dissonance for big enough rewards. The bull market of the 1920s offered such rewards.

> "The first description of stock market activity in Western Europe is provided by Joseph Penso de la Vega in his Confusion de Confusiones. He describes the stock market as a madhouse, full of strange superstitions, peculiar practices, and compulsive attractions."

The crash started Thursday, October 24, 1929. The panic started for no reason. The money market wasn't tight. Banks, brokerages, and industries were not failing. Yet stocks started to drop ten points between trades and, by mid-morning, "air pockets" existed for several stocks, when no bid was offered. On Tuesday, October 29, a wave of sale orders hit the market as speculators tried to cover their margin calls. Glamour stocks collapsed by as much as 75 percent, while other stocks received no bid offers.

The Past and the Present

Does the crash of the 1920s bull market set an example for the bull market of the 1990s? The current bull market has been fueled by similar events. Low interest rates, rapid technological expansion and consumer credit stimulate current speculation. The1990s market was fueled by an explosive growth in mutual funds; in the 1920s, it was investment trusts. But even more significant is the reintroduction of the "paradigm shift" mentality in financial circles. Instead of viewing the bull market as a bubble, many analysts maintain that the present bull market - like the one in the 1920s - is a paradigm shift. They say it is moving away from traditional measures of stock investing to new methods or economies. Talk of a "New Economy" is in full swing.

About the Author

Edward Chancellor studied history at Cambridge and Oxford. In the early 1990s, he worked for the investment bank Lazard Brothers. He is a freelance contributor to the *Financial Times* and *The Economist*.
