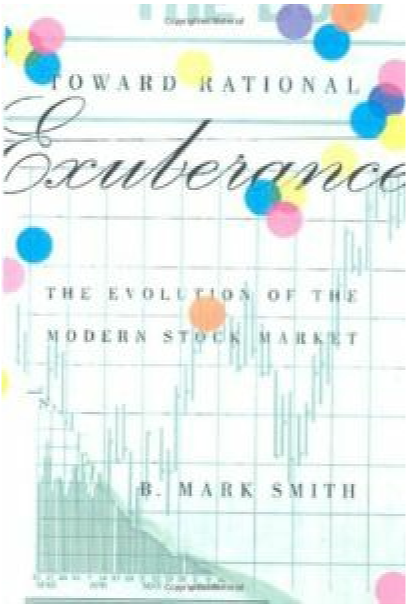

Book Toward Rational Exuberance

The Evolution of the Modern Stock Market

B. Mark Smith
FSG, 2001

Recommendation

Since it now appears that the laws of economics do indeed still apply to the U.S. stock market, it seems a good time to brush up on the history of Wall Street. Such a look back is especially important to the millions of investment bankers, brokers and individual investors who cut their teeth in the "irrational exuberance" of the ’90s and are now catching their first real glimpse of the bear. B. Mark Smith’s comprehensive history of the U.S. equity market demonstrates, if nothing else, that this ain’t the first time a bubble’s burst and it sure won’t be the last. The beauty of Smith’s book derives from his ability to link the development of the market with the history of the times. He begins with the founding of the first exchange in the late 1700s and traces the market’s increasingly powerful role through the last century, when it helped fuel modern technological and economic growth. The book is especially intriguing when it discusses the relatively unknown early years of the market, before its big crash in 1929. *BooksInShort* recommends this fascinating history to executives, financiers and academics, as well as to a broad audience of history buffs, even those with little knowledge about stocks.

Take-Aways

- Wall Street’s first marketplace in the early 1600s traded commodities and slaves.
- In 1792, 24 merchants signed the Buttonwood Agreement, the first formal agreement to sell public stocks.
- Soon after the first non-banking business issued stocks in 1815, many other industries funded factories with stocks.
- The New York Stock and Exchange Board was founded in 1817.
- The American economy’s growth after the Civil War fueled stock market growth, along with corruption and scandal.
- In 1901, John Pierpoint Morgan joined Carnegie Steel’s president to create U.S. Steel and sold stock - one step toward the modern stock exchange.
- Over-speculation caused a series of stock market panics from 1850-1900.
- World War I and World War II contributed to the growth of the stock market.
- The growth of credit and borrowing to buy stocks fueled the 1920s great bull market.
- The notion of the efficient portfolio based on maximizing return within a given level of risk emerged in the 1950s.

Summary

The Birth of A Market

The stock market today is vastly different than it was a century ago. Today millions of Americans participate in a regulated and open marketplace, whereas 100 years ago, the market was controlled by a small group of insiders. The public was mostly unaware of what went on and distrusted the market, especially after it crashed in 1929. To understand today's modern stock market, you need to look at how it evolved from fairly primitive beginnings.

> "Stock market crashes were distressingly common in the second half of the nineteenth century. Devastating panics occurred in 1857, 1869, 1873, 1884 and 1893, and often ushered in severe downturns in the nation's economy."

The first marketplace took root at the eastern end of Wall Street in the earliest days of the 1600s, but it traded in commodities and slaves, not stocks. In the 1790s - after the U.S. Constitution established a strong federal government - trading in financial instruments emerged, dominated by U.S. government bonds and by bonds sold by different states to fund improvements. Stock trading was limited to shares in a few bank and insurance companies. In 1792, 24 merchants signed the Buttonwood Agreement, the first formal agreement creating an association to sell public stocks. This important precursor to the stock market required brokers to agree to charge customers a minimum commission and to give each other preference in their dealings.

Boom and Bust

In 1815, the New York Manufacturing Company became the first industrial business - not a bank, insurance firm or canal company - to issue stock. Although it didn't last very long, it launched a movement. Soon other industrial concerns issued stock to pay for innovative new factories, driven by steam power. These companies needed to issue stocks to fund this development, since the factories required more capital than a single individual could provide. Instead, these businesses set up "joint stock" companies, rather than sole proprietorships or partnerships. These companies eventually evolved into modern corporations, while the stock market became the means by which corporations could raise the needed capital.

> "Stocks were typically viewed by turn-of-the century investors very differently than they are viewed today. They were valued primarily on the basis of the current income - dividends - they produced."

The formation of the New York Stock and Exchange Board in 1817 - which eventually became the New York Stock Exchange - was a pivotal development. Brokers formed the Exchange to create more structure than the original Buttonwood Agreement provided. At the time, trading did not occur within a continuous market and most trading was still in government bonds. Trading proceeded as the president of the board called out, one by one, the names of available securities, so broker members could bid for or offer that security. Transactions occurred when a broker and seller agreed on a price. The process evolved, but most of the Exchange's constitution survived, with various amendments, to the present.

> "The Dow theory assumed that the stock market at all times accurately reflected the sum total of all knowledge as to the future course of business activity much better than any individual could possibly hope to."

In those years, companies issued little financial information; most companies felt their finances were their own business. But by the 1850s, members of the small, elite band of stock traders were speculating heavily. Crowds of 200 to 300 men often gathered outside the Board to trade. Railroad securities became the most actively traded stocks.

> "One hundred years ago the market was a primitive insider's game, lacking in transparency and sophistication and distrusted by the public."

The first big panic occurred in 1857 when a major insurance company collapsed. It was a temporary setback. By 1862, the end of the Civil War fueled another boom. This pattern of boom and bust continued through the rest of the 19th century and into the 20th. The rampant speculation in stocks and the lack of regulation also contributed to widespread corruption, especially in New York City and the state of New York.

> "After 1815 businesses often required more capital than a single individual could provide; hence the joint stock company (the forerunner of the modern corporation) over time became a popular form of business organization, replacing sole proprietorships and partnerships. And the stock market became the vehicle through which joint-stock companies could raise the capital they needed."

After the Civil War, the growth of the American economy fueled even faster stock market growth, along with more corruption and scandals. For example, in 1869, the most notorious late 19th century Wall Street operator, Jay Gould, flooded the market with extra shares of the Erie Railroad as he sought to corner the gold market. Eventually, the Exchange worked to add new rules to protect the public, such as forbidding corporate directors from selling their own companies' stock short. Though the second half of the 19th century was marked by a series of panics - in 1869, 1873, 1884 and 1893 - the market kept growing, spurred in part by the 1869 election of pro-business president William McKinley. Though the government lacked any way to prevent panics, the market recovered as new technologies fueled economic growth.

The Turn of the Century: A Maturing Market

The year 1896 marked the creation of the Dow Jones Average of Twelve Industrial Stocks, devised to provide an index for monitoring the shares of the new industries. At first, the average tracked the railroads and only 12 other companies.

> "The landmark decision (referring to the Northern Securities case in 1901) served notice that big business could no longer operate in a vacuum, free from the restraints of government and public opinion."

In 1901, John Pierpont Morgan, the biggest banker of the day, signed a contract with the president of Carnegie Steel, to create the world's largest industrial corporation: United States Steel. The new giant had capitalization of more than $1.4 billion - which, at that time, exceeded the federal government's $350 million annual budget. U.S. Steel represented a combination of many smaller firms. Though many Wall Street observers thought Morgan had paid too much, Morgan and his associates looked to future profits. Their attitude marked the beginning of a new outlook on the stock market. Traditionally, stock prices were based on the level of dividend payments and the most valued price-earnings (P/E) ratio that was estimated at around 10 to one. When Morgan and his associates issued their first shares of U.S. Steel on Wall Street, demand was tremendous and all the 750,000 shares sold within a few weeks at $55 to $100 a share, far more than the initial $39 per share price.

> "What had started as a struggle between two Wall Street operators for control of a railroad developed into a precedent-setting case that helped establish government antitrust policy for decades to come."

Charles Dow, editor of The Wall Street Journal and creator of the Dow Jones Average, supported these new criteria. In a series of articles from 1900 to 1902, he spelled out theories that became the basis of the technical market analysis approach.

At about the same time, the government stepped in to play a bigger role on Wall Street in response to the battle between Edward H. Harriman and James Jerome Hill, whom J.P. Morgan backed. They fought to control the Northern Pacific Railroad. After a series of manipulations and short sales of various stocks, many short-sellers were ruined as prices rose. President Theodore Roosevelt initiated an antitrust case, which the government finally won, helping to establish U.S. antitrust policy for the following decades.

Hedonistic Excess

Another financial panic hit Wall Street in 1907, due to still another attempt to corner the market, this time in United Copper. J.P. Morgan helped stave off the collapse by gathering contributions from other bankers to create a large enough pool of reserve funds to save the weaker banks. Morgan remained the undisputed king of Wall Street until his death in 1912. Meanwhile, the stock market boomed, getting even more power from World War I.

> "Perhaps the most significant reform enacted during the Wilson administration was legislation authorizing the Federal Reserve System. Designed to be the American central bank, the Federal Reserve began operation in 1914."

As WWI increased demand for U.S. exports, corporate earnings boomed. Stock prices increased, as favorable press coverage of the market generated new public interest in investing. The number of Americans who owned shares skyrocketed, and the stock market became democratized. The big surge between 1917 to 1921 was fueled by the government's Liberty Loan campaign urging Americans to buy war bonds. The Federal Reserve pumped additional funds into the banking system to hold down the government's interest on its war debt. This led many new middle-class people to invest. Then, to combat inflation, the Federal Reserve shifted to a tighter monetary policy. In 1923, it created its Open Market Investment Committee, which became the way the Federal Reserve controlled the U.S. money supply.

The Crash

From 1921 on until 1929, the stock market experienced a great bull market - later seen as a reflection of a period of over-speculation and "hedonistic excess." Although a few Wall Street players, such as Charles Schwab, recognized that the stock market was expanding beyond the potential of the U.S. economy and corporate earnings, others continued to invest. The beginning of the credit industry furthered the boom in investment because it enabled middle-class people to buy consumer products - and stocks - on credit. The crash of 1929 was brought on by several factors, including a decade of over-speculation, fueled in part by broker's loans, which enabled investors to buy stock and use the stock as collateral for loans. These loans increased after 1927, when the Fed implemented an easy-money policy that promoted even more speculation. Growing corporate profits and new methods of valuing stocks based on market forecasts contributed to this boom. By early 1929, some experts could see warning signs about overly high stock prices and speculation. But the reverse leveraging that occurred after the bull market crested on September 3, 1929 finally triggered the crash. After that, the market began a downward slide that snowballed into "Black Tuesday," October 29. As margin calls went out, many investors didn't have the collateral to cover their margin loans.

> "The booming economy, successive Liberty Bond campaigns and an expansive Federal Reserve monetary policy seem to have induced many middle-class people who had never before invested in securities to become stockholders."

Yet, while many analysts viewed the crash as the precursor of the Great Depression a few years later, the 1929 decline was in many ways a price-adjustment period similar to prior panics. Only three to four percent of American households were involved in stock trading and the crash only brought the stock prices back to what they had been in 1928. Stock prices gradually recovered in April 1930. The depression was probably triggered by a combination of factors, including a weak banking system, overly restrictive Federal reserve monetary policies and protectionist policies that reduced international trade. But whatever its cause, the Depression led to increased government regulation, including the Securities and Exchange Act of 1934, which outlawed certain practices, such as insider trading, pools to influence stock prices and deliberately spreading false information. The Federal Reserve Board also gained the power to limit how much investor-speculators could borrow to buy stocks.

Merrill, Markowitz and the Modern Market

Gradually, the economy began to revive with the coming of war in Europe, but the stock market lagged, despite easy credit and expanding production and corporate profits. Many people were still suspicious of Wall Street or ignorant of the financial world. But Charles Merrill created innovative marketing and brokerage-management techniques to attract consumers. In the early 1940s, he merged Merrill Lynch with Pierce & Company, hired Stock Exchange specialists and reached out to middle-class investors. He encouraged comprehensive annual reports and released the results of his firm's in-house research. His approach helped to bring Wall Street to Main Street and provided the foundation for the exploding public interest in stocks after the 1950s.

> "The boom in consumer spending (during the 1920s) was fueled by a new element: credit. For the first time in history, financing was made available on a large scale for middle-class customers purchasing consumer durables."

One key development in the 1950s was Harry Marowitz' development of the efficient portfolio approach, based on maximizing expected return for a given level of risk. Much of the public's increased market participation involved mutual funds, targeted to small investors to enable them to gain a diversified stock portfolio selected by professional managers.

A psychology of optimism backed by pro-growth government economic policy characterized the early 1960s "Kennedy market." The promotion of go-go funds and the increasing participation of institutions in the marketplace marked the later 1960s. By 1969, professional money managers buying for institutions did more than 70% of New York Stock Exchange trading. The bear market in the early 1970s brought further reforms, including the elimination of a fixed commission rate in May 1975. These changes helped set the stage for the development of today's stock market, which is based on government regulation, a mix of theories about stock performance and competition among brokers who can set their own commissions.

About the Author

B. Mark Smith was a professional stock trader for nearly two decades, first with CS/First Boston Corporation, where he became director, then as vice president of Goldman, Sachs & Company. He has since retired from the stock market.