Equities in historical perspective

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> "We learn from history that we do not learn from history"
> – Georg Wilhelm Friedrich Hegel

Since the birth of the modern stock market in 1602, the pendulum of the investment culture has moved from a return focus to a risk focus, and back. After a financial crisis, speculators are often mocked by society, and regulation soon follows.

One way to tame the "animal spirits" of professional investors and truly serve client interests are prudent person principles. The Prudent Man Rule from 1830 can serve as a useful anchor for investors. With the risk of defying a great philosopher, this paper's bold aim is to investigate what investors in the 21st century can learn from four centuries of investment history.

This paper reflects on four centuries of stock market investing. It describes how investment culture tends to be cyclical and mean-reverting and in particular describes two interesting boom-bust cycles. In 1720, the first stock market bubble burst, while the Go-Go years of the 1960s changed the nature of the fund industry to this day. Finally, this paper highlights that today's stock market turnover is high by 1950 standards, but not by 1920 standards.

Bubbles and speculation are caused by so called "animal spirits" of investors, and regulators have created general principles for professional investors to tame these animal spirits. This paper discusses how the Prudent Man Rule was born and how it serves long-term investors.

1. INVESTMENT CULTURE CYCLE

1.1 The first stock market bubble and public response

The first IPO in history was the issue of shares of the Dutch East India Company (Vereenigde Oost-Indische Compagnie or VOC) in 1602. On 31 August 1602, a total capital of 6.4 million Dutch guilders was subscribed by thousands of investors (Petram, 2011). A few years later, VOC stocks started being actively traded on the Amsterdam exchange, later on including forwards, options and even short-selling instruments.

Figure 1: The oldest share of the VOC (1606)

Source: www.oldest-share.com

The first real stock market crash occurred in 1672 when the Dutch Republic was at war with England and France.[1] Even though VOC shares fell 50% in value, the years before this crash are generally not considered a bubble period.

Half a century later however, the market was indeed in bubble territory. In 1720, the Dutch Republic experienced a wave of IPOs of companies with highly speculative business models. Investors participating in this "Windhandel" or "thin air trading" lost most of their investment when the bubble burst later that year. Only one company of the Dutch 1720 IPO bubble survives to this day, the Rotterdam-based insurance company, ASR.

In the same year, Europe experienced its first wave of simultaneous stock market crashes. In England, the South Sea stock bubble burst while in France the overvalued stocks of the Mississippi Company crashed, leaving many newly-made millionaires disillusioned. Both state-owned companies had creatively converted government debt into tradable shares.

After the 1720 bubble, speculators and brokers were mocked in poems and theater plays, in which their greediness and losses were ridiculed. Figure 2 highlights one stock market print from an extensive publication from 1720, called Het Groote Tafereel der Dwaasheid,[2] including the start of a poem, saying:

> "Thou that waste all thy money, intellect and time on bubbles and banks, and want to profit from rising and declining stocks, through which thy are deceived or thy deceive others with thin air, look at this print of screaming and confusing stock brokers."

Figure 2: Pamphlet on speculation (1720)

Gy die in bubbels, bank en zuid,
Uw geld, verstand, en tyd verbruit,
En uit het ryzen of het daalen
Van de Actiën een schat wilt haalen,
Waardoor gy u bedrogen vindt,
Of anderen bedriegt met wind,
Zie hier een Prent van de Actienarren
Die raazend ondereen verwarren.

Source: Het Groote Tafereel der Dwaasheid

The print shows stock brokers offering shares to the public. Most of these companies, listed in the middle of the drawing, went bust in the same year they were offered to the public. This 18th century poem could serve as a useful guiding principle for long-term investors - don't be seduced into risky glamor stocks and don't speculate. Almost two centuries later, a popular Broadway show "The War of Wealth" was inspired by the Panic of 1893.

We skip the stock market crises of 1772, 1792 and many 19th century crashes with 1873 being the biggest. The 20th century saw markets crashing in 1901 and 1907, followed by the famous 1929 crash. It is fair to conclude that boom and bust cycles are as old as stock markets itself.

Today, after the Global Financial Crises, we witness similar responses from society. For example, "De Verleiders" (The Seducers) is a popular theater play in the Netherlands that mocks the role of bankers in the financial crises. "The economics of good and evil", a book by Sedláček, is also translated into a popular theater play in Prague. It is a strong plea for economics being a moral science, with an important ethical responsibility for society. Today, in popular books and on social media, "banksters" and speculators are ridiculed as they were in the 18th century.

Figure 3: Cartoon on banksters (2012)

Source: www.veteransnewsnow.com

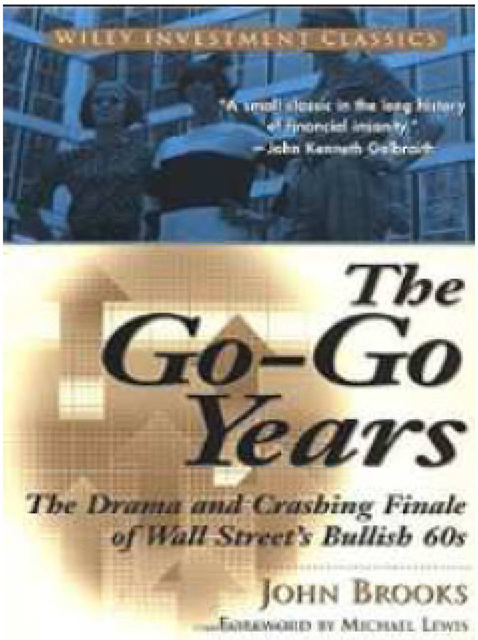
1.2 The Go-Go years in the 1960s

A more modern boom-bust cycle is the period of the so-called Go-Go years of the 1960s. This period is not a very well-known era in investment history, but it is quite relevant in the history of fund investing.[3] It marks the rise of the performance culture with a new generation of star fund managers.

In the 1960s, the investment industry went through a dramatic cultural change. The old, experienced and conservative fund managers who had experienced the 1930s and war time period were overshadowed by a new breed of younger fund managers who had only one goal - short-term outperformance. The traditional virtues of conservatism, diversification and stewardship were replaced by return chasing, speculation and salesmanship.[4] Capital preservation went out of fashion, and beating the market became the new name of the game.

The term Go-Go was popularised by business author John Brooks (Figure 4) and refers to the new culture of fast-moving portfolio managers that rapidly traded in and out of large blocks of technology stocks and conglomerate stocks. Portfolio manager Gerald Tsai of the Fidelity Capital Fund, which became the hottest fund of the Go-Go years, was reported to have an annual portfolio turnover of more than 100%. He concentrated his client's money in a handful of growth stocks like Xerox, Polaroid and Litton Industries. Buying stocks that represented traditional corporate America was considered not exciting enough.

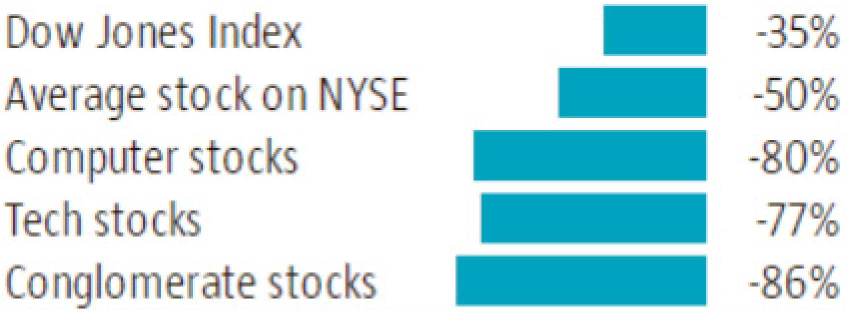
Figure 4: John Brooks, the 'Go-Go Years'



Tsai's results, and those of other high performance funds, were impressive. He became a national investment celebrity and attracted huge amounts of inflows, as did his peers. High-performance funds rose by 40% on average in 1965, outperforming the Dow Jones Average by 25%. The risky growth funds kept on delivering high performance, riding on the back of a strong general bull market, until sentiment turned decidedly around in 1969. Markets plummeted, liquidity dried up and more than 100 brokerage firms were near bankruptcy. The decline in the Dow Jones Index was only half the story. As the index was composed of industrial blue chip companies, it fell 35% from peak to trough in the 1968 to 1970 period. The decline was far more dramatic for popular risky growth stocks with losses up to 86% as shown in Figure 5.

Figure 5: Style performance 1968-1970

1968-1970 peak to trough



Source: Max Shapiro (1971)

This interesting episode in more recent investment history teaches us that riding a bubble can be rewarding and rational for fund managers. By selecting risky growth stocks, fund managers could rise to stardom quickly. The resulting fund inflows directly led to profits for the asset management firm (Karceski, 2002).

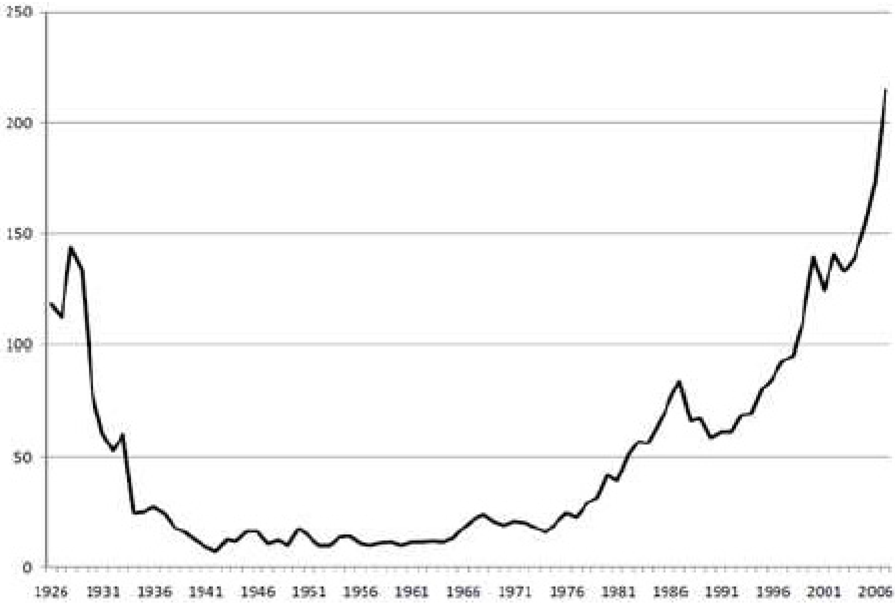
This Go-Go years episode marks the beginning of a change in the investment industry. At the beginning of the 20th century, most money was managed by asset owners themselves, but by the 21st century, most money is managed by professional investors who are focused and incentivised on relative performance. When investing becomes a relative game, the incentives change and might not be aligned between asset managers and their clients.

1.3 1929: Trade like it is 1999

It is interesting that with the growth of confidence, portfolio turnover also went up. What is history telling us? The increase in turnover in the Go-Go years was a sign of what was to come, given the exponential increase in stock market turnover in the decades afterwards. In the 1970s, turnover rose further, helped by the abolishment of fixed commissions on Wall Street, as the SEC deregulated broker commissions on 1 May 1975. For the first time in more than 180 years, trading fees were set by the market again.[5] The resulting collapse in trading costs opened the way to higher turnover.

However, costs are not the only determinant of trading behavior. During the 1920s, at a time when transaction costs were much higher, turnover levels were already above 100% as new technologies like the ticker tape made the stock market more accessible for investor (Figure 6). The deep economic crisis of the 1930s resulted in a change of trading behavior which lasted for decades. Trading remained at lower levels for a very long period. Even during the Go-Go years, turnover levels were still modest by 1920s standards. Only in the late 1990s, did turnover return to the levels seen in the 1920s.

Figure 6: Annual turnover US stocks in percent, 1926-2007



Source: Kenneth French, 2008

2. ANIMAL SPIRITS VERSUS PRUDENCE

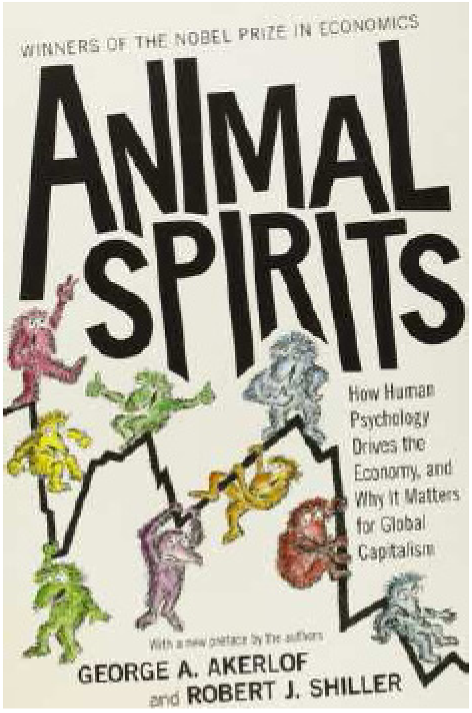
2.1 Animal spirits

Bubbles, bursts and high stock market turnover are caused by what Keynes described as "animal spirits" in his book "The General Theory of Employment, Interest and Money". IN 1936, he wrote:

> "Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities"[6]

Robert Shiller and George Akerlof (2010) used the term in the title of their book about how human behavior influences the economy and financial markets.

Figure 7: Animal Spirits



Related to this, in "Thinking Fast and Slow", Daniel Kahneman distinguishes two neuro systems. System one is our intuitive instinct (animal spirits), and System two is the rational side of decision-making. Our instincts are related to overconfidence, high turnover and poorer investment results.

An important lesson from investment history is that investors' animal spirits are hard to tame, especially in stock markets. Human nature is inclined to act quickly instead of patiently waiting for an investment strategy to show its long-term merits.

Most regulators have prudence principles in place to tame investors' animal spirits and to keep professional investors from excessive risk taking and speculation. These rules function as a check on volatile human nature.

2.2 Prudent Man Rule of 1830

After the 1720 crash, the English court composed a list of proper investments that managers of investment trusts should focus on (Schanzenbach and Sitkoff, 2007). The list favored government bonds and prohibited equity investments, as the 1720 stock market crash was still fresh in people's mind.

One hundred and 10 years later, Massachusetts judge Samuel Putnam initiated a more inclusive list of prudent investments for trustees, including equity investments. It has come to be known as the "Prudent Man Rule", which he introduced in his verdict on the lawsuit *Harvard vs Armory* (Pickering, 1831).

Figure 8: The 'Prudent Man Rule' – Harvard v. Amory, 1830

Source: affordablehousinginstitute.org

Francis Armory had managed money as a trustee for Harvard College, but obtained a negative portfolio return. For Harvard, this was reason enough to start a lawsuit against Armory. Although the stocks Armory had selected did not lead to any profit, in the eyes of Judge Putnam, Armory's investment process was sound as he had focused on stable companies with high dividends. The court stated that:

> "All that can be required of a trustee is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested..."

The Prudent Man Rule allowed more types of investments, including corporate stocks, than its British counterpart. The rule was established half a century before the first market index was introduced and long before benchmarks were used by investors. Many of today's prudent man or prudent person principles are building upon the Prudent Man Rule from 1830. John Bogle, a long-time proponent of passive investing, also refers to this principle in many of his books.[7]

3. REFLECTIONS IN THE 21ST CENTURY

For all the wisdom of four centuries of investing, not much has changed in financial markets. Boom and bust cycles still exist and speculation is higher than ever. It seems animal spirits are still hard to tame, just as they were in 1720.

In fact, Hegel might have been right. First, it's unlikely human nature will change quickly. What is constant over time is the cycle in the investment culture, driven by human behavior. Second, we do not observe that agency problems are being solved. If anything, possible conflicts of interests between asset owner and asset manager are growing in the asset management industry. More and more money is managed by investment professionals, rather than by owners themselves. The market still highly rewards funds with strong recent three-year performance, which is a clear incentive for asset gatherers to increase risk, as in the Go-Go years. Regulators have not created incentives for fund managers to decrease risk. For example, the Dutch regulatory framework for pension funds considers defensive stocks to be more risky than a market-weighted index and Solvency II does not differentiate between low-risk and high-risk stocks.

In today's benchmark-focused investment industry, we should cherish the Prudent Man Rule of 1830. The three virtues mentioned in the original Prudent Man Rule of 1830 serve as a useful benchmark:

1. *"Considering the probable safety of capital"* - avoid downside risks and provide protection of capital. Evidence-based historical insights help in the design of the heuristic long-term prudent investment rules.

2. *Considering the probable income of capital"* - stable income is a timeless client benefit, which is currently popular and will be in demand in the next 200 years. However, this is not always the case - witness the exuberant 1920s, the performance culture of the 1960s and the bubble in the late 1990s, in which dividend was subordinate to capital appreciation.

3. *"Not in regard to speculation"* - reduce downside risk and focus on the long term rather than the short term. Keep things as simple as possible and as complex as necessary and trade as little as possible and as much as needed.

Over the past years, there has been a shift in preferences by some asset owners - more focus on capital protection, income and little trading. Still, animal spirits and agency problems are driving markets. Capital preservation is now more fashionable, but aiming for the highest returns will again become the name of the game sometime in the future.

ENDNOTES

1. Although the Tulip Mania of 1637 is often cited as the first investment bubble, it did not affect the stock market.

2. Author anonymous. Dutch for *The Great Mirror of Folly*, as translated by Goetzmann et al. (2013).

3. The Go-Go years have some overlap with the better-known 'Nifty Fifty' period, although the Go-Go fund managers crashed in 1968-69 while the Nifty-Fifty stocks crashed in the 1973-74 bear market. We highlight the Go-Go years as it caused a cultural change in the mutual fund industry, whereas the Nifty Fifty period didn't. See, for example, Brooks (1973).

4. See, for example, Fox (2009).

5. http://www.sfgate.com/business/article/The-genesis-of-discount-brokerage-1975-SEC-2637815.php

6. https://en.wikipedia.org/wiki/Animal_spirits

7. Interestingly, in his early career, Bogle wrote an article in which he showed that defensive active mutual funds outperformed the market. See Armstrong (1960).

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