

# *Client Letter* *September 2002*

## **Behavioral Economics and Educated Capital Markets**

Last month, Daniel Kahneman of Princeton University and Vernon L. Smith of George Mason University won Nobel Prizes for their work in "Behavioral Economics." While Conventional economic theory says the economy and the markets are always rational. Professor Kahneman and Professor Smith, say "not necessarily"

People get emotional about their money, and emotional people make irrational decisions about their investments. This is not a strange concept to anyone who follows Warren Buffett. Ben Graham's Mister market was nothing if he was not irrational

Vernon Smith, won his prize for running class room experiments to study the behavior of market participants. When he ran experiments trying to create market bubbles he found that it was easy to do. Bubbles are normal reaction to an environment of

easy money and lack of experience.

The part of Smith's experiment that was most interesting to me is when he ran the experiment a second time with the same people. The second time the prices are not as irrational. The bubble starts to re-inflate but this time the participants, burned by their previous experience are more cautious and the values do not become as extreme. The third time the same experiment is run the market has become educated and from then on the prices tend to track intrinsic

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value. In other words markets are not only irrational but they can learn.

The real world it is probably more complicated. In the 1970's it took three or four bear markets to finally exorcize all of the speculative excises that had build up in the market in the fifties and sixties.

## Today's Market

Smith's experiments could go a long way toward explaining the secular (long term) trends in the stock markets. Our last Secular bear was in seventies and the one before that was in the thirties these long cycles could well be explained by a sort of reverse learning curve. It takes thirty to forty years for smart market to forget the lessons of the bear market and turn stupid.

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So if there are smart markets (1977) and dumb markets (March 2000) were we now? Warren says somewhere in the middle, but if the seventies and the thirties are to be our guide it takes a long time for a really

dumb market to learn.

What does the market do next? I think it likely we can expect another attempt to re-inflate the bubble. This would mean something more than the two or three month rally from the September lows, that most people are expecting, followed by a much lower peak followed by another down leg that may my well be worse than the last.

## Behavioral Macro Economics

Beyond what Behavioral Economics tells us about the stock market it may have some interesting things to say about macro economics in general and FED policy in particular.

Financial markets set the tone for the economy as a whole. The stupidity pumping the tech bubble seems to have infected our whole economic identity.

Each new day we learn fresh evidence of some wonderful foolishness that was going on during the bubble years. Last weeks lesson comes from a story in the New York Times about Cigna.

In hindsight the stupidity is breathtaking

" The original bet on the stock market came in reinsurance that the company sold to other companies to cover their risks in writing variable annuities... some companies sold policies with a promise that no matter how badly the mutual funds performed, the policy would pay at least as much as was invested."

So here was a company writing reinsurance to protect investors from a bear market. This is an interesting concept, but you better be darn sure to get the premium right.

"Cigna's reinsurance protected the issuing companies from losses caused by a deep fall in the stock market. The company disclosed last month that it would take a \$720 million charge for the costs of providing that coverage."

**Oopps!**

And if that were not enough,

"The company seems to have fallen victim to the prevailing Wall Street wisdom of the late 1990's that companies should repurchase their shares, whatever the price or value. The implicit assumption was that the companies would never need the capital, or if they did, that they could always raise money on favorable terms. This year,

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it invested \$344 million, buying stock at an average price of \$98.33 a share. It kept buying into July, after the stock market had plunged. On July 24 the company's board authorized more repurchases, which appear unlikely. The price is down, but the company does not have the money to make the purchases...From 1997

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through this year, Cigna spent \$7.4 billion on share repurchases, buying 90.1 million shares, at an average price of \$81.92 a share — more than double the current price of the stock.”

I just point out this example because tells us something of the intellectual impact of the Market Bubble on the Management in Businesses that had nothing to do with Technology or the Internet. There hundreds of examples like this from all different industries and many worse than this.

Professor Smith's experiments indicate that Markets can learn, but that education seems to come mostly from pain. After a bubble inflates it takes a couple of good bear markets before

stock prices begin to return to the area of their intrinsic values. But if markets learn they also forget. The composition of the markets changes constantly, old money managers retire, or get fired, people die, and new investors enter the market. It is not so much people forget what they learn in a bear market, but the new bubble is fed by new people entering the market that have not yet been educated by the bear.

But if it is pain that educates, then it must be an absence of pain that grows stupidity. It is interesting that our tech Bubble formed at the end of the longest economic expansion since the end of World War II Further, if my memory is correct the second longest period of expansion was in the 1960's and immediately preceded the crash of the seventies. So whereas economic pain educates, prosperity seems to make the market stupid.

All this points to new area of operation for the law of unintended consequences. The politicians decide that they can tinker a little and eliminate human suffering. Recessions are bad, unemployment is bad so let's get rid of those nasty old economic cycles. Sir AI, happy to serve, invented the soft landing and presto, no recession for eleven years.

## Greenspan Feels the Heat

Milton Freeman has no love for central banks. He has said that if

he were given the choice he would replace them all with computers. Each computer could be programmed to expand a country's Money supply at some predetermined conser-

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vative figure like 3%. The advantage would be to remove politics completely from decisions about a countries money supply.

A glance back at the twentieth Century indicates that in practice central banks have very limited and ambiguous powers to do good, but an compulsive propensity to solve economic problems by making then worse.

Alan Greenspan when questioned about the role of the American central bank, the Federal Reserve Board, in the recent tech Bubble has grumbled that it was not his fault. If he had tightened more in 1994 or 1998 he would have caused a recession and he is probably correct. The problem is with

his assumption that recessions are bad. Recessions cause pain but they educate the stock market and its participants

The Question we should be asking is; if we had experienced a recession in 1994 and/or 1998 would there have been a tech bubble, and if there had been, would have been so large and so damaging?

**The lesson for the FED from Behavioral Economics is that the Concept of a soft landing solved one Problem only by creating a bigger one.**

Life is, and always will be, ambiguous, every solution has a price. In this case the price of the soft landings was the creation of stupid Capital Markets.

Behavioral Economics tells us that markets learn from pain but forget about rational values after long periods without economic pain. If this is correct then it is likely that concepts such as "Soft Landings" and the "Greenspan Put" fathered a good deal of our recent foolishness, and history will not view Mr. Greenspan's role quite as enthusiastically as the business press does today.

How much the economic tinker-

ing of the FED contributed to the inflation of our tech bubble will be debated for years, but in my opinion Greenspan bears considerable culpability for the magnitude of the silliness.

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