Your Turn

by Jane Hughes

What I Would Tell My Past Students

Recently I've been wishing I could address some of the students I used to teach at Brandeis's International Business School. I'd remind them about my endless rants on debits and credits, on federal bailouts, on financial models.

I think my students learned key lessons, but it looks like many denizens of Wall Street failed to pay attention when they were in business school. Because *every single thing* that has gone wrong in the current debacle was studied and put right in our classrooms. All of this has happened before, and it will happen again until we finally learn the lessons of the past.

Risk and Return

When I was teaching, I liked to draw a risk-return graph on the blackboard and say, "I'll teach you a year's worth of financial theory in 30 seconds. When return goes up, risk goes up. That's all you need to remember about finance." The students would roll their eyes and then race out of class to tattle on me to their other finance professors.

Since the time of William Duer in 1792, every single financial crisis/debacle/scandal in America has reflected a foolish hope that this basic relationship has been overturned. The bankers who loaned gobs of money to Latin America in the 1970s and early 1980s forgot that the reason for the sky-high interest rates on this debt was unacceptable risk. Those who poured money into Enron in the late 1990s were gleefully anticipating 15 percent growth in earnings *every year*, never mind that the company had to take bigger and bigger risks in the natural gas trading market to achieve that growth.

Financial mythology holds that old Joe Kennedy realized that stocks had flown too high in 1929 when his shoeshine boy started giving him stock tips. My own "aha!" moment came at a bat mitzvah in Silicon Valley in 1999, when I was seated next to a newly minted millionaire and entrepreneur. He confided that a venture capital firm had just given him $18 million for a Web site that would provide weather forecasts—despite the fact that weather.com was already offering that service for free. The following week, I told my students the story, and I warned them that the Internet bubble was going to burst.

This time, Wall Street should have had its "aha!" moment when banks started offering mortgages with zero percent down and no credit approval process. When markets become stupid, a crash is inevitable.

Derivatives Fallout

Veteran Wall Street banker Felix Rohatyn famously warned in 1994, "Twenty-six-year-olds with computers are creating financial hydrogen bombs." If Part One of the current mess is the mortgage market's descent into madness, Part Two is the derivatives fallout.

As I told my students, derivatives themselves are not evil. Derivatives are simply financial products that derive their value from underlying assets, including gold, foreign currency, oil, and stocks. Used for good, derivatives can help companies protect themselves against price fluctuations and stabilize the economy.

Misused, however, derivatives can be hydrogen bombs. I loved to teach the case study of Nick Leeson, who landed at Barings Bank Singapore in mid-1992. His job was to make risk-free trades between the Singapore and Japanese stock markets, to take advantage of tiny price differences.

Instead, Leeson made unauthorized trades in derivative products—and manipulated a secret account to hide his losses. He was viewed as a star trader at the bank's headquarters in London, lauded for having single-handedly earned one-half of the 1994 profits for the entire firm. Apparently no one was even mildly curious about how these fantastic profits could result from such a low-risk operation.

In the end, Leeson fled, leaving behind a handwritten note that said, simply, "I'm sorry." Barings—banker to the English royal family and one of Britain's most venerable financial institutions—was suddenly insolvent. The Bank of England chose not to intervene, and eventually the Dutch bank ING agreed to assume most of Barings' liabilities for one pound.

Fast forward to 2008 and AIG. Like Barings Singapore, the insurance giant's London unit was run by an individual who received almost no oversight from the parent institution. Joseph Cassano plunged into the arcane world of derivatives trading, like Leeson, and initially recorded enormous profit margins. But as the credit crisis unfolded in 2007-08, Cassano's derivatives portfolio suffered $25 billion in losses that swamped the London unit and eventually the entire company. The U.S. government bailed out the insurer for $85 billion.

Blind Faith in Financial Models

Nothing provoked more eye-rolling in my classroom than my disdain for financial models. "I could teach you a fancy model for foreign currency options pricing," I would tell my students, "but it doesn't work." I might add, "Stop trying to quantify the unquantifiable, and have a little more faith in analysis and experience. Common sense trumps models."

My tirades reached a peak in 1998 with the federal bailout of Long-Term Capital Management (LTCM). LTCM was a hedge fund founded by a group of Nobel Laureates and financial whiz kids, who created a model that enabled them to take huge, highly leveraged risks in global financial markets. For a time LTCM earned fabulous returns, but in the end it foundered on its blind faith in the efficacy of financial models. Remarkably, LTCM's brilliant models had not taken into account the correlations between markets, especially in bad times; when things go bad, they go bad all over. A lot of things went wrong at once, and the Fed brokered an extraordinary rescue of LTCM by 14 leading banks.

To me, LTCM represented a new low in the annals of U.S. banking. In fact, reliance on models can produce even riskier behavior since it lulls traders into a false sense of security—much like a skier wearing a helmet may ski more recklessly than someone with a bare head.

"And don't even get me started on the Fed's intervention," I would warn. I would point out that this is why banks and traders take excessive risks—because they believe that the government will bail them out in the end. Or else they believe they're too big to fail (AIG), too connected with other banks to fail (Bear Stearns), or too connected with power brokers to fail (everyone else). Once the risk-return tradeoff is subverted, markets will get stupid again. And again. And again.

It's the People, Stupid

Occasionally I would reminisce in the classroom about my early days as a "baby banker." I couldn't remember all five C's of credit—*collateral, covenants, cash flow,* and something else—but I always remembered the most important C, *character.*

Long after my students have forgotten debits and credits, I suspect they still will remember my story about the CEO of an up-and-coming Southern company with which I worked during my baby banker days. I brought the vice chairman of the bank—my boss's boss's boss's boss—down to meet with this CEO. But the CEO was distracted throughout dinner by several attractive flight attendants at the next table. He sent over champagne, winked and flirted, and ended the evening by bearing them off to an impromptu party in his hotel.

My boss's boss's boss's boss was unamused. "Cut them off," he ordered me as we drove back to the airport. "I'm not trusting my depositors' and shareholders' money to a man who can't keep his mind on business when one of America's top bankers comes calling."

I nearly drove the car off the road. It was many years before I fully came to understand how much character actually counts. But that was before I learned of Tyco's CEO Dennis Kozlowski, who billed the company for a $6,000 shower curtain for his Fifth Avenue duplex. And before I knew about Wall Street "analysts" who hyped hot new stock issues to their unsuspecting clients while their internal e-mails trashed the stocks as "dogs."

And what are we to think of Wall Street traders who packaged dodgy mortgages into incomprehensible derivatives with valuations that defied logic—all for the sake of the $30 million Manhattan penthouse or the third home in Vail? Today's public outrage over executive compensation is nothing more than a rerun of the outrage over Michael Milken's $550 million pay package in 1987. This outrage distracts us from the real reforms that are required—but market participants do need to feel real pain before lessons can be learned and incentives can be readjusted.

Remedial Studies

Truly, there is nothing new under the sun. Finance wizards who seek enormous rewards must, by definition, be running enormous risks. Finance wizards who put their blind faith in models must, inevitably, be disappointed. And princes of finance who lose their moral compasses in pursuit of absurd riches must, invariably, turn into frogs. Those who do not remember the past are condemned to repeat it—ad infinitum and ad nauseum.

Perhaps we should bring some Wall Street types back to business school for remedial studies. I'm sure my students could help them learn some of the business basics we studied in my classrooms long ago. Z

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