THE BANALITY OF TRUST: WHY FINANCIAL MARKET BUBBLES AND CRASHES HAPPEN

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Financial crises occur when market participants realize that asset prices have reached levels that are far in excess of their fundamental or intrinsic values. Intrinsic values are based on “reasonable assessments” of the fundamentals that drive asset values- informed market participants’ assessments of future cash flows and current rates of return required by informed investors. Students of finance are trained to compare the intrinsic value of an asset to its price. If intrinsic value exceeds price, then buy, if below, then sell. Given that presumably everyone knows this fundamental principle, how is it possible for asset prices and their intrinsic values to periodically get so far out of line? If investors as a group are “doing their homework” and they are acting on the analysis conducted, price trips from intrinsic value should be very short lived under most circumstances. Contrary to popular wisdom, it does not matter that some market participants lie and cheat, provide misinformation hoping to take advantage of the less informed. As long as other investors recognize the misinformation and act on this knowledge, then misalignment between price and value should not last long. The theory of countervailing power, the combat between the “longs and the shorts”, creates a market balance that should preclude the formation of bubbles.

But financial history, and more specifically recent financial history, indicates that this is not true. First there was the 2000 tech bubble followed by the largest real estate bubble in history in 2008. These bubbles cannot be explained by standard economic theory. There is a dynamic at work that we simply do not fully understand. Nevertheless, let me posit a thesis that may shed some light on the factors that create bubbles and are curiously operative even now. My hypothesis can be stated quite succinctly: Asset prices run up and begin to exceed intrinsic values when investors reach a point where their TRUST in the judgment of others replaces their own. We can call this the suspension of disbelief or what can be termed, in the spirit of Hannah Arendt and Martin Heidegger, the zone of thoughtlessness. What drove the villagers in Hans Christian Anderson’s famous fable to insist that the emperor had clothes when it was clear to anybody that can see that he does not? When trust in the wisdom of others replaces one’s own thoughtful judgment, when trust becomes banal, investors choose to stop searching for evidence that disproves accepted wisdom: They ignore the vast abundance of information that might stimulate the basis for renewed valuation skepticism. It is not that market participants do not trust their own judgment; they simply stop judging. Moreover, it is not the average person on the street that suspends disbelief; it is the investment professional, the expert, the financial advisor and consultant who stop doing their “homework”. When enough of these trusted individuals act thoughtlessly, bubbles emerge. Bubbles become crashes when thoughtlessness ends, and thoughtfulness takes over.

The financial markets work best when investor trust and investor skepticism are properly balanced. Proper balance occurs when “accepted wisdom” is not central to making an investment decision. Properly functioning markets require at least two critical elements: a substantive level of trust between investors and facilitators of buying and selling financial assets and skeptics who, among other things, verify that this trust is well founded. In short, trust and verify becomes the

key operating principle. When this balance is "right", conventional wisdom is routinely challenged in the marketplace and markets function optimally as allocators of risk capital. When there is an imbalance, when trust becomes banal among financial market participants, financial capital is not properly allocated, that is it is over allocated to certain asset classes and under allocated to others, and bubbles become increasingly possible.

The imbalance between trust and skepticism is set in motion when investors do less analytical due diligence (think independent research) and promised returns still emerge. There is no penalty for being less skeptical. Less analytical due diligence occurs when either of two conditions are met. The first is that requisite information is either not available, or if it is, the cost to obtain it is too large relative to the perceived benefits from obtaining it. The second occurs when there is too much information and the cost of sifting through it is large. Under both conditions, too little and too much information, investors have two options: withdrawing and investing in safe assets or continuing to invest in risky assets and accept the transparency risk associated with not having sufficient information to make an informed investment decision. Withdrawal is not a real option for the largest investors- pension plans, endowments and foundations- since their future funding requirements require earning rates of return that are far in excess of what can be earned from riskless assets like Treasury securities.

The first condition-lack of information- presumably no longer represents a real constraint: regulation has forced issuers of securities and their agents to disclose all relevant information necessary to make an informed investment decision. However, when disclosure yields a voluminous amount of data about very complex investment instruments, market participants naturally seek to minimize their due diligence burden. They do this by selecting professionals they believe to be knowledgeable, and they trust to provide the guidance they need. Their natural skepticism wanes as the cost of trust and verify outweighs the perceived benefits. In the limit investors and their advisors march to the same beat. They reproduce the same message. Alternative views slowly and imperceptivity disappear. The state of thoughtlessness emerges when we all or most of us share a common view.

Although there are many examples of this phenomenon, a recent example of this is when an investor or his agent accepts the credit risk assessment of a credit rating agency without dispensing even a cursory level of due diligence designed to test the validity of the credit rating. If a well-known credit rating agency concludes that a financial security has a low credit risk, it must be so. It really does not make any difference that the firm issuing the security is also paying the credit rating agency for the security to be rated. If one harkens back to the mortgage crisis, one of the things that stands out is the number of "well informed investors" in CDOs that apparently never read the prospectuses that described the securities they were invested in. How many of the investors in ABACUS, the Goldman CDO, actually read the prospectus, which by the way is very detailed. In fact, it has so much detail, one could understand how prospective investors interested in finding out the terms of the CDO pays off might glaze over and simply conclude if a well-respected Wall Street firm was offering the security it must be OK. Is it Goldman's fault that investors trusted what they were told? As far as I know Goldman did not lie; it simply gave the investors the prospectus and said here is another opportunity to invest in the U.S real estate market. My point is that when investor trust becomes banal, bad things happen.

When bubbles lead to crashes and subsequent recoveries, one would think that investors would be sensitive to restoring and maintaining the optimal balance between trust and skepticism. But

surprisingly they are not. Some years ago, Axiom conducted a survey of the due diligence procedures applied to opaque investments by endowments and foundations. All the respondents invested large sums of money in hedge funds. When asked how many hedge fund managers disclose their underlying investments so investor managements can undertake the requisite analysis to ensure that the reported investment values are correct, close to half of the respondents indicated that their managers refused to disclose. When asked how investor managements assured themselves that the reported values were correct, more than half said they communicated with managers and felt “comfortable” that the values were correct. Moreover, respondents reported that they did very little relevant analytical due diligence to ensure reported values are correct and their auditors appeared to be “comfortable” with their due diligence practices. It seems almost incomprehensible, considering Madoff stealing hundreds of millions of dollars, the rating agencies not doing proper due diligence on many of securities rated, that fiduciaries responsible for billions of dollars would be so trusting. Yet they are.