Knowledge Bank

THE SIGNAL-TO-NOISE RATIO

By Duncan MacPherson

Use my summary of John Kenneth Galbraith's book A Short History of Financial Euphoria to add impact to your messaging to be compelling and attractive to clients and prospective clients:

As a financial advisor, you know all about the distinction between the message and the messenger. The message is more about the products and services you provide and the firm you represent. The messenger is more about you and your ability to be the indispensible voice of reason to clients during times of intense turbulence and uncertainty

With elections looming and countless issues swirling around the globe, the velocity of noise that your clients are exposed to is dizzying. Your goal is to help them tune out that noise and tune in your message of clarity and leadership.

Investing the Past into the Future

The prognosticators in the media know that there is no marketplace for good news. In order to get peoples attention they stir the pot of negativity and gloom. To counter that, I urge you to consider adding an historical perspective to your messaging.

I realize that these are unprecedented conditions and that people crave predictions and a vision for the future so that they can face it with anticipation rather than apprehension. But nobody really knows if it's in fact "different this time." Probably the most important thing you can do is to simplify your messaging and ask your clients to look back – way back – so that we can separate market conditions from human nature as well as the cycles, peaks and valleys of the investing world.

Every now and again, especially when things look especially bleak in the world markets, I like to review this summary I created after reading *A Short History of Financial Euphoria* for the first time. John Kenneth Galbraith takes readers on a substantial tour of world history as it relates to the markets and the mindset of investors and reminds us that while things and events may change, human nature does not. Greed, fear, ambition, self interest, trust, confidence and other emotional drivers have always played critical roles when it comes to market fluctuations.

So take a quick read through this summary and consider how you might integrate history into your conversations with your clients. It reminds me of simple and immutable laws of investing including this favorite by Sir John Templeton:

> *"A Bull market begins on pessimism, grows on skepticism, matures on optimism and dies on Euphoria."*

And keep in mind that the most attractive and refer-able financial advisors in the business do not swim in a pool of sameness. They are unique and compelling because they stand out from the pack. They get the attention of clients and are memorable because of the effort they put in to their client relationship management activities.

A Short History of Financial Euphoria – A Synopsis

By Duncan MacPherson

In his foreword to the 1993 edition of *A Short History of Financial Euphoria*, economist John Kenneth Galbraith writes that investors "might be reminded of the way not only fools but quite a lot of other people are recurrently separated from their money in a moment of speculative euphoria."

We feel it prudent to revisit this minor classic. After all, in December 1999, Business Week magazine confidently heralded the new century by printing, "We're running with the bulls again this year. The big story of 2000 is likely to be tech stocks, how far and how fast they will rise." As we all remember, that prediction was proven inaccurate, as the tech bubble soon burst and markets fell. How does that old adage about "hindsight" go?

In *A Short History of Financial Euphoria*, Galbraith examines significant episodes of speculative boom and bust during the past four hundred years, so that their characteristics can be defined and understood. With this information, he hopes to equip investors, as well as all people who work with money, with the insight to protect themselves during a market run-up, what he calls a period of financial euphoria. Galbraith is certainly not confident that regulations will ever be able to achieve such security for investors.

According to Galbraith, speculative episodes start with something capturing the financial imagination, driving up an item's price or the price of an entire sector. This increase attracts new buyers. Speculation starts to build on itself as more investors jump on board. Those on board talk the investment up, further building interest in it.

There are two types of participants in speculative markets:

1. Those who feel the run-up is under control and that the market is adjusting to a new, higher norm, and
2. Those (fewer in number) who perceive that the market spike is a result of momentary speculation, and who want to ride the upward wave and get out before it crashes on the rocks of reality.

Specific Features of a Speculative Episode

1. Something new is being offered. In 1636, it was tulips. In the 1980s, it was junk-bonds.
2. People's egos and pocketbooks are rewarded (but only in the short term) for getting on board early.
3. Debt becomes out of proportion with the underlying means of payment. For example, in Y2K, margin accounts were called in when tech stocks corrected, causing further declines in share value.
4. The market crashes. Things always fall. And with a bang, not a whimper. Financial operations do not lend themselves to innovation. The reason for this sudden downward change is because both groups mentioned above are predisposed to escape quickly. Something, it doesn't matter what nor how insignificant, triggers the exit. None of this information, however, is new.

The period following the crash is marked by anger against those who had been so recently seen as savvy, recrimination and unsubtle introspection. Rarely will the speculation itself be examined. Why? Because too many people were involved; there's no satisfaction in blaming a community of fools. And because society holds the market as the "totem of free-enterprise, it looks to external force or else abuse of the market to explain its failure.

Benefiting from Financial Euphoria

According to Galbraith, investors can benefit from a speculative boom if they resist two compelling forces:

- A powerful personal belief that investment success was intelligently earned.
- The pressure of public (and seemingly superior) financial opinion.

Resistance to these forces is extremely difficult because it goes against the very momentum of the episode and its advocates. Those who predict a fall are viewed as doomsayers by both of the above groups.

Two other factors contribute to financial euphoria:

- Short financial memories.
- The association of money with intelligence.

In the free-enterprise world, the talent for making money is associated with the talent for social and economic perception, and with careful thought: "the more money, the greater the achievement and the intelligence that supports it," Galbraith writes. We also tend to associate this genius with the leadership of the great financial institutions. Specifically, we believe that the more assets under management, the greater the perception of those running them. In addition, we defer to those who have money to lend. Galbraith reminds us of the old industry saying, however, that "financial genius is before the fall." After the fall, no one looks so smart.

After analyzing the characteristics of a Speculative Episode, Galbraith spends the remainder of the book, fully three-quarters of it, examining historical examples of such episodes. He discusses the Tulip Mania of 1636-37 in Holland, the Banque Royale fiasco in France and the South Sea Company bubble in England during the early 18th Century. Galbraith then crosses the Atlantic to analyze the Great Collapse of the New York Stock Exchange 1929 and Black Monday in October 1987 (United States). These analyses drive home Galbraith's point - that speculative periods follow the patterns he outlined at the beginning of his book.

Lessons Learned from Economic History

In his summary, Galbraith suggests that while history can teach us lessons best not to be missed, economic history lessons are somewhat ambiguous because of the process of continuous transformation in the field of economics. That aside, he feels that when controlling circumstances are the same, the lessons are clear. Galbraith summarizes the lessons to be learned:

The circumstances that induce the recurrent lapses into financial dementia have not changed. Individuals and institutions are captured by the wondrous satisfaction from accruing wealth. The associated illusion of insight is protected, in turn, by the oft-noted public impression that intelligence, one's own and that of others, marches in close step with the possession of money. Out of that belief comes action, the bidding up of values, whether in land, securities or, art. The upward movement confirms the commitment to personal and group wisdom. And so on to the moment of mass disillusion and the crash. This last, never comes gently. It is always accompanied by a desperate and largely unsuccessful effort to get out. Those who are involved never wish to attribute stupidity to themselves. Markets are also theologically sacrosanct. Some blame can be placed on the more spectacular or felonious of the previous speculators, but not on the recently enchanted (and now disenchanted) participants. The least important questions are the ones most emphasized: What triggered the crash? Were there some special factors that made it so dramatic or drastic? Who should be punished?

Galbraith suggests that not much can be done about this situation beyond having a better understanding of the speculative process. In his customary wry manner, he warns:

There is the possibility, even the likelihood, of self-approving and extravagantly error-prone behavior on the part of those closely associated with money. When a mood of excitement pervades a market or surrounds an investment prospect, when there is a claim of unique opportunity based on special foresight, all sensible people should circle the wagons. Perhaps there is, indeed, opportunity. A rich history provides proof, however, there is only delusion and self-delusion.

Things may change, but human nature stays the same.

A Short History of Financial Euphoria by John Kenneth Galbraith is published by Viking Press, 1994 (hardcover), 110 pages; and by Penguin Books of Canada, 1994 (paperback).

Continued Success!