What Went Wrong?

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I doubt if the way out of the present imbroglio lies in programs, regulations, or bailouts. It is simpler and deeper than that. It is not an event; it is a syndrome.

We have forgotten prudence.

Prudence is the first Christian cardinal virtue (followed by fortitude and justice), and it is incidentally the central duty of investment managers. The Prudent Man Rule, which since 1830 has told trustees what they must do, has recently been replaced in all 50 states by the Prudent Investor Rule, which every trustee must obey and which, indeed, should be understood by anyone who looks after the investments of others. But either way, the key word is *prudent*.

The old rule instructed the trustee to look around, observe how men of prudence and discretion looked after their affairs, and be guided accordingly. Alas, that has become exceedingly hard. When I was young, and even today to some extent in England, if a citizen had a financial question, he would visit his "bank manager" to seek seasoned counsel. Or he might consult a college friend who had become a stockbroker, perhaps in a family-controlled firm, and who understood life. He had to be able to count on his adviser to be objective, to put the client's interest first.

Not anymore. Objective advice scarcely exists in banks and brokerage firms, which are in business to sell "products," some of which, such as all commodity and currency speculation, are intrinsically imprudent, designed to make money for the house at the expense of the customer.

The old Wall Street rule is "If the ducks quack, feed 'em." That is, when the cry is, let's all buy houses (or emerging markets, or hedge funds, or whatever), which "can only go up," then push them, hard! But such people are hustlers, not professionals.

The effect of all this on the fortunes of imprudent investors can easily be shown. The most obvious measure is the stock market itself. Depending on the period you choose, the very long-term total return of stocks, in general, is around 9 percent before inflation. For funds, you subtract costs. But the long-term return for individual investors is only half of that. Why? Because the average investor is imprudent. Convinced that she can outsmart the other average investors, she buys equities when the excitement is high, toward the top of the market, and then, discouraged by falling prices, sells again toward the bottom, running up costs both ways. The market itself is thus a Ponzi scheme—and not only the whole market but also the hot segments as they come and go. To coin a phrase: Nothing *ex*ceeds like success.

And take note that the end of every great bull market is that time's version of a margin account, enough different from the last one that most people do not recognize it for what it is. Obviously, leveraged buyout booms and hedge fund explosions are margin accounts because they are done with borrowed money, and so are houses bought for higher prices than one can afford with mortgages one cannot pay.

The way out of this misery is well known: prudence. Buy and hold quality issues for long periods. It should always have been obvious that the crowd cannot outtrade the crowd. Thus, the correct solution is to trade as little as possible; above all, resist tips and inspirations.

Then, consider imprudence at the governmental level. The housing bust was, in part, caused by the government pushing a good idea, encouraging home ownership via Fannie Mae and the like, beyond where it should go. In essence, it used political objectives to warp the logic of economics.

There could not be more obvious folly—or worse—than luring financially weak homebuyers in over their heads, when they ought to be renting, and letting them pay with wormy paper whose quality is then falsely certified by ratings agencies,[1] which are compensated by the sellers. And to further compound the problem, this wormy paper is then flogged off to trusting foreign buyers.

Or how about using the inflated value of our houses as a credit card? Or, nationally, how about buying goods we cannot afford from the Chinese in return for IOUs they may not find useful?

So, how do we learn prudence? Nobody is born prudent. The infant is a bundle of impatient desires. The Greeks had a maxim: *pathe mathos*—learn through suffering. Our Great Depression and the German hyperinflation after World War I—which prepared the ground for Hitler—burned their messages into people's consciousness with a branding iron. World War II taught Italy and Japan a dreadful lesson about militarism. In mountain climbing, when the guide, having learned his craft through the loss of men he knew, says, "Don't go," then nobody goes. He's unbudgeable. But we have almost no unbudgeable leaders today.

So, besides experiencing the punishments life reserves for folly, how, then, are we to learn?

One way is through teaching, both from our parents and in school. This is a far more agreeable way to form character than is the inferno of financial ruin. The problem, though, is that at times the elders may themselves be lacking in wisdom.

Consider, for example, the following, adapted from Plato's *Republic*, Book VIII:

> The father starts to behave like a child, and stands in awe of his sons; and a son behaves like a father, and no longer respects his parents…

[1]Warren Buffett, the principal owner through Berkshire Hathaway of Moody's Investors Service, a prime culprit, has not commented on its role.

> The schoolmaster fears and flatters his pupils… the young copy their elders, and compete with them both in talking and acting; older men are jocular, like the young, so as not to seem morose or domineering.

Sound familiar? Isn't this where we are today?

Plato continues by explaining that democracy is destroyed by the object it defines as supremely good, freedom. He says that in a democratized city, you will be told that it has, in freedom, the most beautiful of possessions and that such a city is the only fit abode for a free man.

Plato goes on to say that in due course, the citizens of an overripe democracy resent even the slightest infringement on their liberty of action, with the result that such a state ceases to be self-governing. In *Maxims, Opinions and Characters, Moral, Political, and Economical, Volume 1*, Edmond Burke makes the same point in different language: "It is ordained in the eternal constitution of things, that men of intemperate minds cannot be free. Their passions forge their fetters."

I doubt if many of our young are taught these ideas.

The Chinese know quite a lot about life. They are our partners in a curious pact: We will buy your cheap goods, and you will accept our disappearing paper. Now we are printing a torrent of greenbacks, and the Chinese have fired a shot across our bow: Hold on, they are saying. If you want to pay us in funny money, we may move to another playground. The Chinese are in essence requiring that for the game to go on, we must save more, cut our trade and federal deficits, and plan realistically. We will need to work harder, spend less, and postpone our hopes.

But these conditions are no more than any long-term investor should ask. In my lifetime, a shoeshine in New York City has gone from 10 cents to $4, and the 10 cent subway fare to $2. It has been disastrous to save. Confidence in prudent control of our currency has itself become a highly imprudent bet. This is a symptom of social decomposition. The Chinese are quite right to hesitate.

So, what will it take for us to change our ways? The decay in our practices and our education will not be taught by parents or schools or the media unless we insist on it. And that will not happen until we have learned by suffering—*pathe mathos*. Let us hope it does not take too long.

