

## The View from the Land of Steady Habits

More years ago than I care to count, I worked for a mutual savings bank in south central Connecticut. The institution was founded in the early 1840s, in those optimistic days of the new Republic before the Civil War when the ideals of American democracy were fresh and the country's frontiers seemed limitless. Banks were built to look like Greek temples out of admiration for the earliest democracies. The mutual savings banks were chartered to serve working people and bore names like Mechanics Savings Bank or Farmers and Mechanics Savings Bank or the Dime Savings Bank. They were not intended to promote home ownership, they were intended to promote savings, what, in quainter times, was called thrift—a seemingly anachronistic ideal in these days of debt and consumption.

Sadly, the mutual savings banks are almost all gone now. Although they lived through and survived the Civil War, the panics of the late 19<sup>th</sup> century, the advent of central banking, the Great Depression, and the high inflation of the 1970s, they were undone by the same forces as those that have perturbed the global capital markets since July 2007: greed, short-sightedness, and excess. Although one could read both the demise of the savings banks and the sub-prime mortgage mess as morality tales, both are stories of how we fail to understand the feedback loops in investing and economic behavior.

Ironically, it was the more stringent federal regulation of the mutual savings bank industry that set the stage for its demise. Prior to being lumped in with federally chartered savings and loan associations, mutual savings banks enjoyed broad state-chartered investment powers, including the power to invest in equities. They were able to issue variable-rate mortgage loans long before federal S&Ls, and it was largely on account of their broad powers that they were able to weather the high inflation of the late seventies and early eighties. However, once the S&L industry got into trouble, the mutual savings bank industry was lost. Revised federal regulation superseded state-granted investment powers and mutuals effectively lost their broad investment powers.

With the change in investment powers came higher risk-based capital standards. Many mutuals had sufficient capital to maintain a moderately diversified asset base, but not to continue holding equities. Banks either had to raise capital or to find alternative ways of diversifying their assets or both. Some went public and raised capital, at least partly spurred on by the lucrative compensation packages never before available to senior managers of mutual institutions. Many sought diversification and higher returns through commercial real estate lending, an area where the banks had some niche expertise and experience.

The results were a disaster. As mutual savings banks converted to public ownership, too much capital flowed into New England, the region where the mutual savings banks had a large presence. Banks had too much money to put to work. Lenders were paid aggressive incentives to make loans. Everyone saw the market for their individual projects, but no one asked how the overall market could support all of the projects. Banks assumed that

the low loan loss experiences they had in the past would continue. Credit risk analysis didn't see the big picture or factor in the market consequences of the very lending activities they were underwriting. Too much development occurred. Commercial real estate values plummeted. Financed projects were left incomplete or stood vacant for years. Loan losses soared, and banks disappeared as regulators merged the savings banks undone by commercial real estate lending into healthier commercial banks. Fourteen mutual savings banks are left today in Connecticut out of sixty-five that operated in 1980.

The parallels between the history of Connecticut banking and today's global capital markets are not exact, but the themes are similar: excesses in one segment of the market, commercial real estate in one, the sub-prime mortgage market in another, have had wide repercussions. In both cases, the excesses were brought on by too much capital seeking above average returns from a particular market. In both cases, investors were fooled into thinking that past patterns of performance could be sustained regardless of the amount of capital fed into the market and were largely oblivious of the changes in economic behavior brought on by the additional capital: mortgage originators overlooking the interest of their clients for commissions, borrowers taking advantage of eager lenders to borrow more than was prudent or to speculate in housing prices, securities underwriters and rating agencies eager for the business volume, investors anxious to earn above-average returns on the higher-risk tranches of the securities constructed from the sub-prime mortgage cash flows – with risk assessments that did not take into account the behavioral feedback that would compromise the whole market.

We too often forget that finance is not an engineering discipline but a social science. Its subject is essentially human behavior. Capital markets are not closed systems with fixed rules governing their performance. The actions of market participants not only move the market, they can change the basic economics underpinning the market. Unlike a fair roulette wheel where it makes no difference to the outcome of a spin if all of the bets are on red, financial markets are profoundly affected by where the bets are placed. They not only affect the outcome of the games, they sometimes upset the games themselves in ways we cannot anticipate.

What's the lesson for endowment managers, trustees, and investors? First, beware of feedback effects and of thinking that our choices don't affect the market. They are the market, and our choices change the market. As a corollary, remember that the market we observe is not the market we participate in—our trading affects it. Second, learn to anticipate how markets, their underlying fundamentals, and the economic behavior of those directly or indirectly affected by the market might change if many investors act the same way. Third, learn to think like a contrarian. What is the consensus outlook? What would have to happen for the consensus outlook to be wrong? What economic behaviors are likely to flow from the consensus outlook? Can these behaviors undermine the consensus outlook? In the final analysis, the real lesson is that investor behaviors can themselves be the source and cause of market disruptions—not just from direct effects such as driving prices too high, but from indirect effects such as providing incentives for economic agents to act in short-sighted ways that may ultimately compromise the market.