

Peculiar Facts From 500 Years of Finance

By Timothy Knight

Article Highlights

- Holland's tulip bubble was fueled by both a virus infecting flowers and another virus infecting humans.
- "The Wonderful Wizard of Oz" is full of allegories to late 19th century monetary policy.
- The U.S. real estate and financial crisis was preceded by a similar type of crisis in Thailand.

If you are like most people, you learned history in classes that largely covered facts related to dates, places, and people...and you probably couldn't wait until the school bell rang.

Sadly, children's exposure to history is often framed in a way that is less interesting and engaging than it could be, and it robs students of a curiosity about the past that could benefit their own future by understanding the richness of the human experience.

When it comes to the intersection of the financial markets and human history, there is a kaleidoscope of tales drawn from centuries of market mischief, mishaps and mayhem. This article reveals a few less-known but notable events drawn from the past half-millennium that might pique your own interest in the rivers of time that have led us to the present day.

Holland's Famed Tulipmania Was Driven by Two Viruses

You are probably acquainted with the fabled "tulipmania" that gripped Holland during the early 1600s. What most people don't know is that two viruses played central roles in this drama.

The tulip bulbs themselves were classified into three groups: the single-colored, the multi-colored, and the



"bizarres." This last category is most important, as bizarres were the rarest and most sought-after tulip. The reason these unusual flowers came about was due to a virus that interfered with the plant's ability to create a uniform color on the petal. It is today known as a "breaking" virus, since it breaks the plant's lock on a single petal color without killing the plant. The effect on the flower was striking, producing mosaic-like flames of color on each

petal. Of course, the Dutch of the time knew nothing of such things; they merely took a strong liking to these rare and unusual flowers.

As tulipmania neared its frenzied peak, an outbreak of bubonic plague emerged in the land. The psychological effects of this varied from person to person, but for some, it created a reckless, fatalistic disregard for financial risk, since no one was sure if they would be alive or dead in the months ahead. The same plague was also to blame when an important auction of tulip bulbs took place and not a single buyer showed up, ostensibly out of fear of the disease. Of course, plenty of sellers were there, but with no one to sell to, it swiftly became apparent that the top was in, and holders of the bulbs scrambled to get out at any price.

1720s France and 1930s U.S. Share an Important Similarity

In early 18th century France, John Law had revolutionized finance in the country by introducing paper money in lieu of

specie (money in coin). As the frenzy surrounding the mania known later as “The Mississippi Scheme” turned into panic, banks were under terrible stress from holders of the paper notes who demanded their “real” money (that is, precious metals) back.

As the crowds pressed in, the Royal Bank took measures to try to slow down the extraction of real money from its vaults. For example, if a person came to withdraw gold in exchange for notes, the teller would count out the change at a comically slow pace, thus frustrating the others in line and reducing the amount that physically could be taken out in the business day.

Another trick was to put clerks in line who were instructed to withdraw some gold and then simply return the coinage to the vault immediately afterward. This practice slowed down legitimate customers even further merely by making the lines longer.

Two hundred years later, a similar situation occurred in the U.S. as “bank runs” became commonplace during the Great Depression. Between 1929 and 1933, more than 43% (10,763 out of 24,970) of commercial banks in the country failed. Some banks, desperate to stay in business, resorted to ridiculous measures. One Utah bank instructed its tellers to work as slowly as possible, counting out small bills one by one, in order to reduce the pace at which money was being extracted by anxious account holders.

Although two centuries had passed, it seems there had been no innovation in methods of stalling anxious customers during a financial calamity.

Sir Isaac Newton Got Burned by the Bitcoin of His Day

The digital currency bitcoin famously ascended to unthinkable heights in 2013, only to crumble from its peak value during the first four months of 2014. A similar trajectory was experienced by shares of the South Sea Company during the time of Isaac Newton.

As mythic a figure as Newton is, he was still human, and he had watched

jealously as his friends made fortunes in South Sea shares. He jumped on board early in 1720, enjoyed a portion of the ascent in the stock’s price, and sold at a profit. As the stock kept climbing, he elected to put even more money in this time, hoping to “catch up” with the gains his peers had enjoyed.

Although the great scientist got to enjoy the stock’s final vault to above 1,000 pounds, he watched, dumbfounded, as South Sea fell by its own form of gravity. In the second half of 1720, Newton’s holdings created a loss of 20,000 pounds before he dumped all his shares. His earlier profits were wiped out, and his misadventure with South Sea was a financial folly from which he would never recover. He said of the experience, “I can calculate the movement of heavily bodies, but not the madness of men.”

Lincoln Almost Violated the Constitution Over a Hoax

Abraham Lincoln has the status of a near-deity in U.S. history. After years of civil war, however, he became an unwitting actor in an elaborate hoax. Following the hoax, he came dangerously close to infringing on the right of free speech enshrined in the U.S. Constitution.

During the war, the opportunities to profit from gold’s dynamic price movements were not missed by the unscrupulous, and one fascinating account from 1864 captures this neatly. In May of that year, after four years of war, the Union was growing hopeful that a successful conclusion might be in sight.

However, on May 18, the morning papers the New York World and the Journal of Commerce came out with shocking news. They reported that the president had ordered an additional 400,000 men to be conscripted into the Union army on account of “the situation in Virginia, the disaster at Red River, the delay at Charleston, and the general state of the country.”

The discouraging report and the demand for such a huge quantity of fresh soldiers sent a shockwave through the

financial community. This was because the report made it seem obvious that things were not going nearly as well in the war as believed. Stocks tumbled, and hard assets such as gold soared in value. Some people became puzzled, however, because this important report was nowhere to be found in any of the city’s many other newspapers.

Late that morning, crowds had gathered at the offices of both papers that had published the news. The editors assured the crowds that the story was true, producing the dispatch from the Associated Press with the matching information. The Associated Press, however, the ostensible source of the information, quickly issued a statement making clear that they had never sent out this dispatch. This soon caught the attention of the State Department in Washington with Secretary of State William Seward declaring the news dispatch to be “an absolute forgery.”

It turns out that the forgery was a clever creation of Joseph Howard, the city editor of the Brooklyn Eagle newspaper. Howard, who was intimately acquainted with the workings of New York’s newspapers, had come up with a scheme. He knew that bad news from the war would cause gold to rise in value. He also knew that the best way to get a dispatch into the morning papers would be to submit the dispatch when the newspaper staff was most vulnerable—that is, in the wee hours of the morning, when there were hardly any personnel around to verify the facts.

Howard worked with an accomplice to craft a realistic-looking Associated Press news release. Howard, along with Francis Mallison (a reporter for his journal), then distributed the news item at 3:30 in the morning to New York City’s newspapers. Most of them were reluctant to print such an important piece without verification, but two of them proceeded to run with the story.

Of course, before any of this took place, Howard acquired as much gold as he could in his margin account. Once the grim news was raging throughout the financial community, he disposed of his position at a handsome profit,

Spotting Bubbles

There's no magic secret to spotting a bubble: After all, if there were, bubbles wouldn't last for very long. One consistency about bubbles is how obvious they seem in hindsight. As we now look back on the Internet bubble, the Hunt silver debacle, the South Sea bubble, or any of the others, it's all too easy for us to shake our heads at the foolhardiness of our ancestors and take comfort in our newfound wisdom. If only this were ever the case! Humans will always be able to concoct a new and, for its contemporaries, undetectable bubble.

Analogies to the past can be helpful, however, since—as the old saying goes—history may not repeat, but it does rhyme. There are a couple of big challenges to drawing parallels between the past and the present, however. First, as the world speeds up, through such developments as improved communication and new technologies, it becomes necessary to “translate” instances of the past to

modern-day equivalents. The kinds of rumors or narratives that might have spurred on a market in the past might have spread “like wildfire” a hundred years ago, when “wildfire” could have been measured in weeks instead of milliseconds.

The other challenge, and probably the most important, is trying to divine when a top is at hand, even if the bubble is relatively obvious. Those who took advantage of the “top” in NASDAQ stocks in late December 1999 would have been extraordinarily close to pinpointing the peak of the bubble, but they would have also suffered a complete portfolio wipe-out as Internet stocks vaulted a final 100% in the waning weeks of the tech bubble. Although speculators will undoubtedly leave money on the table by waiting, it's probably wisest to wait until it's evident that the bubble is deflating before taking action, even if you miss the first portion of the move downward.

never suspecting the false item would be traced back to him.

It was, however. President Lincoln ordered the closure of both papers that had printed the dispatch, an order that was later rescinded. Lincoln's furious demand for the paper's closures, however, became one of the few black marks on his presidency since, in spite of the ugly circumstances involved, it went right to the heart of freedom of the press guaranteed by the Constitution.

The irony to the newspaper hoax was that only two months later, Lincoln did indeed order the conscription of more men into the Union army. However, the figure demanded was not the 400,000 that Howard had dreamed up for his bogus news release. It was, in fact, a full half million. Howard's fanciful fraud was, in the end, prescient.

The Wizard of Oz is a Precious Metals Allegory

Late in the 19th century, there was a widespread struggle in the U.S. over whether silver or gold, or a combination, should be the basis for “sound money.” The drama around this debate was captured allegorically in a popular children's

tale published around the time entitled “The Wonderful Wizard of Oz.”

The book was written in the late 1890s by L. Frank Baum during the throes of the gold/silver political dichotomy. The major elements of the book represented the circumstances and characters of Baum's surroundings:

- The yellow brick road was the gold standard;
- The silver slippers represented the silver standard (the slippers were changed to ruby in the movie version for aesthetic effect, since color in movies was very unusual in those days and the ruby slippers were very showy on screen);
- Dorothy Gale represented everyday American people who had been, metaphorically speaking, swept away to an unfamiliar circumstance by gale-like forces beyond their control;
- Emerald City represented the “greenbacks,” the political contingent—that is, the citizens themselves—that supported unbacked paper money;
- The Wizard, who runs Emerald City, was the disingenuous politician who appears to be powerful and wise but is, in fact, a foolish man behind a

curtain who is trying to frighten and control regular people;

- The Scarecrow, stuffed with straw, was the American farmer;
- The Cowardly Lion was William Jennings Bryan, the leader of the silver movement (Bryan was widely characterized by critics as indecisive);
- The Tin Man represented America's industrial interests;
- The Wicked Witch of the West stood for the American West; and
- The flying monkeys were the displaced Native Americans of the West (in the novel, the leader of the monkeys tells Dorothy, “Once we were a free people, living happily...this was many years ago, long before Oz came out of the clouds to rule over this land”).

In the end, of course, Dorothy simply has to make use of the silver slippers—which she could have done at any time—to return her to the simple, safe, and secure life she yearned for.

J.P. Morgan Held Bankers Captive to Get What He Wanted

Before the U.S. had a central bank,

its closest equivalent came in the form of one man: J.P. (John Pierpont) Morgan. On more than one occasion, he single-handedly averted a major financial crisis (often profiting handsomely by doing so).

During one particularly dangerous crisis in 1907, known later as the Rich Man's Panic, Morgan brought together the most important bankers of the country to address the crisis on a Saturday night, and he gave them use of the library at his opulent New York mansion to do so. Morgan told the men that they needed to come up with a solution to the problem, and he left the library to attend to other matters. Only later did the bankers realize that Morgan had literally locked them inside the library.

When Morgan entered the room some time later, no consensus had been reached, so he told the men that they needed to come up with \$25 million to shore up the trust companies through the crisis or else the city would face unmanageable panic. After considerable prodding, Morgan was able to persuade the de facto leader of the group to sign an agreement to advance the funds, and the rest of the men followed suit. The agreement having been reached, Morgan produced the key and allowed the bankers out of the library at 4:45 that Sunday morning. Having successfully satisfied their leader (and captor), they were permitted to go home.

The Real Estate Crisis Had a Prequel in Thailand

You are already well familiar with the real estate crisis that gripped the U.S. starting in 2007. A full decade before that, and half a world away, Thailand experienced its own peak and collapse, although the origins of the high valuations were somewhat different from our own.

Thailand was one of the "Asian tigers," Southeast Asian economies that had attracted so much investment and speculation in the early 1990s. An important conduit for the free-flowing credit that pushed real estate higher was a large commercial bank named Finance

One. For years, it had borrowed dollars from overseas banks and made loans to Thai developers in the local currency, the baht. This had been a profitable strategy, provided that regular payments kept flowing in from Thai business.

However, the first sign of trouble took place in February 1997, when property developer Somprasong Land announced that it was defaulting on its \$80 billion loan portfolio, since it was unable to even make its \$3.1 million interest payment. Other developers, who had their own bad news but had been hesitant to make public their misgivings about their ability to pay, swiftly followed in Somprasong's footsteps.

The details behind Finance One's default were grim: Its non-performing loans had doubled during the course of 1996, and in the first quarter of 1997, the quantity of non-performing loans doubled once more. As the banking sector in Thailand looked increasingly shaky, the Thai baht began to lose its footing as well. The Thai government responded by frantically deploying its own U.S. dollar reserves to try to shore up the baht.

What this required of the Thai government was to buy up baht and sell off its dollars. On the books, the government showed that it had depleted its dollar reserves down to \$33 billion. What was hidden from the public, however, was that the amount in reserve was close to a mere \$1 billion, since the government had already tied up so much collateral in currency futures contracts. When the Thai leadership finally announced that it had "discovered" this information, it was forced to let the baht float freely, which put the currency into a free fall, along with the nation's real estate interests.

Of course, the shock waves from a relatively small Asian economy were not as severe as would be experienced with the United States' own real estate debacle. The Thai crisis was, nonetheless, an interesting precursor to what happens when the close partnership between a nation's government, large commercial banks and real estate developers takes a turn for the worse.

OPEC Was Born in Texas

Most Americans understandably think that Organization of the Petroleum Exporting Countries (OPEC), was conjured up in the Middle East as a tool to artificially support crude oil prices, but the model for OPEC was actually an American creation. The U.S. organization was called the Texas Railroad Commission (TRC). It was established late in the 19th century in order to, as the name suggests, regulate railroads. As the 20th century dawned, and the decades passed, the domain of the TRC began to spread far beyond just rail lines, particularly with respect to energy resources. In spite of its name, the modern-day Texas Railroad Commission holds sway over many local industries with one notable exception: railroads.

The TRC's control of production levels in the oil industry gave it tight control over oil prices for most of the 20th century. Although it was established in Texas, the TRC was a crucial arbiter for the "Seven Sisters"—the big U.S. and Dutch oil producers—since no other body was so influential in controlling the price of crude oil. The countries outside of this domain closely studied the TRC's practices and effectiveness, since they had ambitions of their own about being bigger players in the global energy markets.

For much of the 20th century, oil was a relatively cheap and plentiful commodity. This made the focus of the TRC suppressing production levels to avoid a repeat of the crash in oil prices that Texas suffered in the 1930s, when a barrel of oil could be had for as little as 25 cents. The principal oil-producing states of the U.S. (Texas, Louisiana, and Oklahoma) had excess oil capacity, and the TRC had to regulate the flow in order to keep the price high enough for the industry to operate profitably. This was not always an easy task, since it is always tempting for any member of a cartel to break rank and increase their own profits by selling more of the product in question, but the TRC had been a consistent-enough enforcer of

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is the risk of being underinvested in a rapidly rising market, as occurred in 2013. Table 1 shows a partial list of mutual funds with more than 20% of portfolio assets allocated to cash as of December 31, 2013.

How can an investor determine if a fund's managers have the ability to raise cash or whether they must remain fully invested? The answer is most commonly found in the fund prospectus. Under Principal Investment Strategy, look for language that says something like "Normally, the fund will invest 80% of its net assets in the equity securities of

small-cap companies" (if it is a small-cap fund). If you see that type of disclosure, you know the fund has a mandate to remain at least 80% invested. In the absence of such disclosure, it's probably a safe to assume the manager has the flexibility to let cash build, although you may want to call the fund to confirm.

Conclusion

There will always be disagreement on whether it is better for a fund to remain fully invested and absorb the market's volatility or to build cash

reserves when investing opportunities are scarce.

Investors should know where their managers stand on the issue and which approach works best for them. Knowing what managers must do with cash will help an investor know what to expect and ideally use their funds more effectively.

After several years of bull markets, now is not the time to become complacent. Shareholders would be wise to assess now how their funds will behave if the market or a particular asset class goes down instead of up. ▲

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Portfolio Strategies

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production ratios to garner the obedience of the oil producers in its domain.

After World War II and until the end of the 1960s, the nominal price for oil remained within a relatively narrow band of \$2.50 to \$3.00 per barrel. (In inflation-adjusted terms, this spans from \$17 to \$19.) Oil and its by-products were typically American and always cheap, which led to a boom in large, gas-guzzling American automobiles. There was little need for energy efficiency on either the road or in gas-heated households. America had more oil than it knew what to do with.

Around this time, in 1960, OPEC was founded by five member countries: Iran, Iraq, Saudi Arabia, Kuwait, and Venezuela. So even from its inception, OPEC was not an entirely Middle East entity. In the decade that followed its founding, other countries joined the organization: Algeria, Libya, Nigeria, Qatar, Indonesia, and the United Arab Emirates. So while OPEC had a strong

Arabian presence, it actually spanned three different continents.

History's Lesson

As we study and learn of the oddities and disruptions that take place over the course of time, probably the most financially germane phenomenon is the asset "bubble," which has taken many forms over the centuries, some of which have been mentioned here such as tulipmania and the South Sea bubble. The commencement, inflation and bursting of these bubbles follow a template common to similar financial catastrophes throughout human history, running along these lines:

1. Some kind of shift happens (political, technological, or otherwise) that opens up extraordinary profit opportunities that did not exist before, and early participants thrive;
2. As word of the profits spread, a larger and more diverse array of

individuals participate, and as opportunities become more scarce, leverage, excessive trading, and outright fraud begin to creep in; and

3. Once the original model can no longer support the participants, or once a fatal flaw is unveiled in the scheme, there is a rush to the exits. After most participants are badly damaged financially, there is a outcry from the public for justice to be rendered against as many culpable parties as possible. Upon reflection, most of the participants recognize they really didn't know what they were doing in the first place.

As history continues to unfold before you, keep this template in mind: It may provide the impetus to get on board with a potentially lucrative investment while in its relatively early stage, or it may save you from joining the crowd near a top, only to see yet another one of history's bubbles burst in front of your eyes. ▲

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