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Brent Sheather's RESEARCH

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1929: INSIDE THE GREATEST CRASH IN WALL STREET'S HISTORY – AND HOW IT SHATTERED A NATION PART 2: LEVERAGE IS A TWO EDGED SWORD

In my last column we kicked off a four part series reviewing Andrew Ross Sorkin's recent tome, 1929, in which he chronicles the events leading up to, during and after, the Great Crash of 1929. Sorkin makes the point that the crash wasn't a sudden event caused by a few days of panic, rather that it was the result of years of speculative behaviour, based on excessive leverage and a widespread belief that the good times would continue forever. A particular strength of "1929" is that Sorkin is able to combine economic history with stories about the individuals and their decisions that shaped history. The whole crash thing has been covered by lots of different authors but Sorkin's effort adds another dimension through his access to previously un-researched archival material and it is easy for someone who went through the 1987 crash to see parallels in behaviour.

So to understand why the 1929 crash was so severe in terms of its amplitude, and the time it took to recover, and why its impact on the average person was so pervasive, it is important to realise the extent to which it was funded by debt. Leverage was employed both personally by individuals (via margin loans) and by way of the borrowings within the listed investment vehicles which were so popular at the time. The consequences of this debt financing was exacerbated by the fact that the 29 crash was a major deflationary event: the "animal spirits" of optimism and confidence, dominant in the 20s, abruptly

switched to pessimism and fear. Post crash the general public not only stopped believing in a prosperous future, they were confronted with major issues with regard to the present so ceased all discretionary spending. Supply outstripped demand and prices fell: in the period 1929 to 1936 US inflation averaged negative 2.4% pa with prices falling by a massive 10.3% in calendar 1932. In a time of falling prices debt rises in value in real terms. Economists describe the economic environment post the 1929 crash as a debt-deflation. Economic theory on this subject was heavily influenced by the work of the economist Irving Fisher who argued that excessive debt combined with falling prices create a vicious cycle whereby debt burdens rise in real terms, borrowers default, banks fail, the supply of credit contracts and the economy spirals downwards. Alan Greenspan conducted a great deal of research on The Great Depression and was of the view that policy failures, following the stockmarket crash, rather than the crash itself, was responsible for the lost decade of the 1930s. His research on that period explains his own and subsequent Federal Reserve responses to financial crises whereby interest rates are cut and liquidity supplied to the market.

Sorkin argues that debt was one of the key forces that transformed the 1920s bull market into a speculative bubble and was a major factor explaining why a crash in stock prices devastated the world economy. In the book

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he outlines how margin borrowing spread far beyond professional investors. By 1929, speculation had become a national pastime involving ordinary households, businesspeople, celebrities and politicians. Easy credit, combined with widespread optimism that stock prices could only rise, fuelled an extraordinary increase in leverage. As share prices climbed, investors borrowed even more, creating a self-reinforcing cycle. When prices finally began to fall, the same leverage accelerated the collapse as margin calls forced investors to sell into a declining market. The scale of the growth was remarkable. Broker loans expanded from roughly **US\$1.5 billion in 1920** to about **US\$8.5 billion by October 1929**, while broader estimates of total margin credit exceed **US\$20 billion** at the market's peak. **Between one and two million Americans** held margin accounts by 1929—an unprecedented level of retail participation given that the population of America was just 58 million adults in 1929. A key theme in the book is that margin lending did not cause the crash by itself but it introduced a dangerous level of vulnerability: once prices began falling people got margin calls and when they were not able to “front up” more collateral their brokers required them to sell thereby accelerating the downward spiral and turning what might have been a correction into a wholesale collapse.

Borrowing money to buy shares wasn't just limited to margin loans – another feature of 1929 were the listed trusts, companies listed on the stock exchange, also with high levels of debt. These companies were formed to own shares in other companies, including other investment trusts. Back in 1990 I printed off an NBER paper entitled “The Bubble of 1929: Evidence From Closed End Funds”, by Bradford De Long and Andrei Shleifer, from Harvard and the University of Chicago respectively. I thought it might be relevant and 36 years later here we are! Covering the investment trust bubble could easily constitute another couple of stories but some of the main facts are as follows:

- “New closed end fund issues in the third quarter of 1929 reached their highest level ever”. Apparently all the new issues of companies in mid 1929 were closed end funds and they immediately went to large premiums to NAV e.g. the Shenandoah Corporation started trading at 103% premium to its NAV when it listed in 1929. What this means is that the share price of Shenandoah was 103% higher than the market value of the companies owned by the fund. Investment companies trading at premiums to NAV send a signal to their promoters that they should originate more investment companies and, of course, that's just what they did.
- “The median closed end fund *premium* in the third quarter of 1929 was about 50%”. However by January 1930 the average *discount* of US closed end funds was around 28%. This move alone, from premium to discount, constitutes a 52% downshift in the market price of the investment trust. But that's not even close to describing the trajectory of the typical investment trust: They were geared and frequently those investment trusts would own shares in other investment trusts and some times investment trusts would own shares in investment trusts which also owned shares in other investments trusts. Sorkin recounts the story of The Shenandoah Corporation. That company was floated by Goldman Sachs with enormous publicity and investor enthusiasm. A large shareholding in Shenandoah was owned by the Goldman Sachs Trading Corporation which was itself leveraged. Shenandoah then sponsored another investment trust, BlueRidge Corporation, which owned shares in public companies, again with leverage. So an individual in 1929 might have borrowed money on margin to buy shares in the Goldman Sachs Trading Corporation (GSTC) which in turn had borrowed money to buy shares in Shenandoah which in turn had

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borrowed money to buy shares in BlueRidge Corporation ie leverage on leverage on leverage to own companies which themselves were partly financed by debt. GSTC was floated at \$104.00 per share, rocketed to \$220.00 per share within a few months but by 1932 it was worth just \$1.75 – a loss of 99.2%.

- "In the late 1920s closed end funds sold at large premiums to NAV. We interpret these premiums as a sign that investors in closed end funds were optimistic. At the peak in the summer of '29 they appeared willing to pay perhaps 60% more than post-World War II experience would suggest is the "normal" relative price of a closed end fund. Such a substantial overpricing suggests that other assets might have been selling at prices above fundamentals as well".

To the best of my knowledge, I only had one client who bought shares on margin in the 80s. He wasn't from Whakatane, was a few years younger than me, and I met him through the Society of Investment Analysts. He would deal pretty much in one stock, buy maybe \$50,000-\$100,000 worth and then when the price had risen that would allow him to buy more shares on margin as the firm which financed him had regard to the share price in terms of its security over the loan. This happened for maybe 18 months as the share price of the company concerned rose strongly. He was also "short" Pacer Kerridge shares, which ultimately paid off big time and used to joke to me that he was "the shortest man in town". I remember going to the nicest hotel in Auckland and the staff greeting him by name and saying his normal table was available. We stayed at his house in Auckland once – it was probably worth about \$2.0m back then. He kindly let us stay in his bedroom and I remember rows of shirts and suits, all the same. Reminded me of the Great Gatsby. It was definitely wild times and one other thing I remember is him ringing me at 3.00 am one night when he mistakenly rang my number thinking he was ringing someone to

trade S&P 500 futures in the US. He was a real character and a nice man but I lost touch with him and just this month found out that he had passed away.

That is enough for today – in three weeks' time we will look at the experiences and disparate fortunes of one of the major players in the 1920-1930 period.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.