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Excavating Finance's Past

What lessons does financial history hold for today's advisors?

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For the past three years, *Research* magazine has been running "Historical Research," a regular feature on financial history. We've covered topics ranging from the dot-com boom of the nineties to the newborn financial markets of the 1790s, from Dutch East India Company shares to biotech exchange-traded funds and from fictional Hollywood stock scandals to the real-life one that toppled 1930s Wall Street titan Richard Whitney.

As the writer of these articles, I'm pleased to delve into such interesting topics, and to have a beat offering a vast supply of potential future material. Financial history is a compelling subject, partly because it's colorful but also because it's relevant, offering context and comparisons that help make sense of current issues and future prospects.

Now, with a few dozen "Historical Research" articles in the archives (they can be found via www.advisorone.com/research-magazine), and with a few years' perspective on the current financial turmoil, it's a good time to contemplate some themes that emerge from our study of financial developments over the decades and centuries. Here are five history lessons that advisors would be well-advised to keep in mind.

1. Financial people aren't very popular.

Polls show a dramatic decline in public confidence in financial institutions during the past several years. That's not surprising, given the recent history of market convulsions and government bailouts. But public displeasure with the financial sector should not be dismissed as some temporary mood or cyclical pattern.

Consider: Gallup has been asking people how much confidence they have in financial institutions since 1979. That year, 60 percent said "a great deal" or "quite a lot." In 2009, that figure was 18 percent, a record low, and this year it ticked slightly upward to 20 percent. Confidence in financial institutions trended downward even through the booming eighties, and stayed well below its 1979 peak during the soaring nineties.

Moreover, anti-financial feelings form a persistent thread through American history, going back long before there were polls. Politicians have been running against Wall Street since around the time 24 brokers formed a stock exchange by a buttonwood tree in 1792. Thomas Jefferson and his political allies railed against banks — not just a central bank but all banks. In later eras, politicians ranging from Andrew Jackson to William Jennings Bryan to Ron Paul drew upon popular distrust of financial types.

As a financial advisor, you face the challenge of earning and building your clients' trust. History underscores that such confidence is not easy to win or to keep. Your clients may like you but not feel so sure about your firm or your bosses or the investment vehicles you're steering them into. Also, don't be surprised if elected officials and regulators show less-than-total sympathy for you and your fellow professionals.

2. Crises are never a thing of the past.

Shortly before the Great Crash of 1929, economist Irving Fisher famously stated: "Stock prices have reached what looks like a permanently high plateau." Such optimism that we have moved beyond financial downsides in some lasting way has been a recurrent feature of market psychology. It reappeared in the 1960s, fueled by go-go stocks and a belief that Keynesian economists knew how to fine-tune the business cycle. It showed up yet again in early-21st-century proclamations of an economic and financial Great Moderation.

Economists Carmen M. Reinhart and Kenneth Rogoff, authors of the 2009 book This Time It's Different: Eight Centuries of Financial Folly, cite the belief that "this time it's different" — in other words, that unlike in the past, we now know how to avoid crises — as a key factor in causing financial turmoil. That's because the complacency of thinking risks are under control leads people to take bigger risks.

The safer bet is to assume that you haven't seen your last serious financial crisis, and that your clients haven't seen their last one either. On a brighter note, history's litany of crises can offer some solace that, bad as things might be at the moment, they typically were indeed worse, and sometimes quite a bit worse, at various points in the past.

3. Personalities matter.

Financial history is filled with moments when an individual had some major impact. Alexander Hamilton became Treasury secretary in 1789 and spent the next couple of years remaking — or, largely, just making from scratch — the financial landscape of the new United States. It's far from clear whether anything similar would have happened had he not been at the Treasury. Perhaps the U.S. would have remained a financial backwater.

In the Panic of 1907, J.P. Morgan Sr. rallied bankers to stem the financial chaos. Nobody else, including President Theodore Roosevelt, seemed up to the task. Seeing so much power in one private financier's hands then spurred politicians to create the Federal Reserve System. But personalities matter in both the public and private sectors. New York Fed Governor Benjamin Strong, who might have been a reassuring figure during the 1929 Crash, unfortunately had died the year before.

There doesn't seem to be any iron law that determined that hedge funds would appear in financial history in the years after World War II. Rather, that reflected the personal creativity and initiative of Alfred Winslow Jones. In 1970, Robert Haack, renegade president of the New York Stock Exchange, defied powerful

players on Wall Street and his own institution by calling for an end to fixed commissions, giving the industry a major push toward the great unfixing of May Day 1975.

For decades, academic financial theory, built on the efficient-markets hypothesis, emphasized the abstract and mathematical. But finance is an activity conducted by people. On a theoretical level, behavioral finance has been important in taking account of human idiosyncrasy. On a practical level, a financial advisor who thinks of the job as number-crunching for cookie-cutter clients is bound to fail. History suggests you can't ignore personalities — whether you're assessing your clients' needs, your partnership prospects or how much confidence you have in a Treasury secretary or wirehouse CEO.

4. Financial innovation is crucial.

In the wake of the Great Meltdown, financial innovation is viewed with great suspicion. Some innovations turned out to be duds, or at least to have problems and exposures that were poorly disclosed and understood. The auction-rate securities market is effectively dead, for example, and few would argue these days that its benefits justified its risks.

The history of financial innovation, however, is not some one-sided litany of duds and debacles. Rather, many products and techniques that were cutting-edge for their time have done much good. One wonders, for instance, how companies would have coped with floating exchange rates without the currency futures pioneered by Leo Melamed at the Chicago Mercantile Exchange in the 1970s with inspiration from Milton Friedman.

Or consider how G. Keith Funston, the New York Stock Exchange's president in the 1950s, set up innovative installment plans to get people back in the stock market and build up "people's capitalism" a quarter century after the Great Crash? Would it have been better if Wall Street had accepted risk aversion and capital scarcity as post-World War II America's inevitable "new normal"? Clearly, the answer to that question is no.

As an advisor, you have the critical task of sorting through financial innovations on behalf of your clients, to determine which products and techniques are suitable and recommend them accordingly. You also may need to help clients understand that there is little choice but to innovate, since the strategies of the past are not necessarily the ones that make sense going forward.

5. Your job will keep changing.

The system of fixed commissions that began with the 1792 Buttonwood Agreement and ended with the 1975 May Day reform had the effect of limiting competition in the brokerage industry. Even so, stock brokers never really had much assurance of a placid or predictable career. Things could be shaken up by crises and new technologies. If you'd started working about a century and a half ago, you'd have been buffeted by the Panic of 1857 and the advent of ticker machines in 1867, not to mention the Civil War in between.

In the past three and one-half decades, competitive pressures, plus technological advances and financial turbulence, have transformed the industry. "Brokers" have become "advisors," with new pay arrangements and broadened missions. Business has been dispersed geographically such that the term "Wall Street" is becoming anachronistic too. The clubby, insular atmosphere of the brokerage industry of yore has few vestiges.

There is little reason to think this period of heightened change is over. On the contrary, emerging developments — a tighter regulatory regime, the baby boomers entering retirement, the federal government facing vast fiscal pressures — all point toward advisors needing to rethink and retrain on an ongoing basis. A key lesson of history is that your job is going to keep changing, and you'll have to be nimble to thrive.

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Some Noted Scholars
Looking to delve further into financial history? Here are a few experts whose works you should check out:

- Ron Chernow, biographer, is the author of books including *Alexander Hamilton: A Life and The House of Morgan* .
- Niall Ferguson, history professor at Harvard, wrote The Ascent of Money: *A Financial History of the World* , a book that served as the basis for a PBS documentary. His most recent book is *High Financier: the Lives and Time of Siegmund Warburg* .
- John Steele Gordon's books include *An Empire of Wealth: The Epic History of American Economic Power* and *Hamilton's Blessing: The Extraordinary Times of Our National Debt* .
- William L. Silber, professor at NYU's Stern School of Business (and not related to this article's author), wrote *When Washington Shut Down Wall Street: The Great Financial Crisis of 1914 and the Origins of America's Monetary Supremacy* .
- Richard Sylla, also of NYU's Stern School, has written widely on financial history. He serves as vice chair of the Museum of American Finance, located in lower Manhattan.

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Kenneth Silber is a senior editor at *Research* magazine. His work on science, economics and history has appeared in a variety of publications, including *The Wall Street Journal* and *The New York Post* . He appears on a monthly radio show on the Business Talk Radio Network.