I recently wrote a post about a book I really liked called America’s Bank, by Roger Lowenstein. The book talks about the formation of the Federal Reserve, and the events that led to it. One of the major catalysts that started the process of banking reform was the Panic of 1907.

On a related note, Seth Klarman’s favorite books include everything by Roger Lowenstein
What Caused the Panic of 1907?

Basically, the Panic of 1907 was caused by a classic run on the bank, leading to the failure of the Knickerbocker Trust company in New York, which drained cash reserves from the financial system and created a shortage of liquidity all over the city and eventually in the broader economy. Merchants couldn’t use credit to pay for inventory, cash wasn’t available to pay workers, farmers couldn’t sell their crops, and the economy entered a recession.

The First Domino

It all started with a routine speculation that went awry. In those days, it was common for “stock operators” to borrow huge sums of money to finance an effort to manipulate a stock price for their own personal gain. The big speculators and their syndicates had enough buying power to move the prices of even the largest stocks.

In October of 1907, one of these operators, a banker named F. Augustus Heinze, attempted to corner the market of a copper mining stock. The operation failed, and the stock, which reached a price of 60 during the attempted corner, almost immediately collapsed to 10. Because of the leveraged nature of these manipulations, Heinze's bank, Mercantile National Bank, was feared by the public to be bankrupt. In fact, Heinze's bank was still solvent, but in banking, perception can become reality, and as depositors pulled their money out, Mercantile needed an emergency loan to stay alive.

On its own, the prospect of a small bank failure shouldn’t have been more than a blip on the economic radar. But without a central bank to act as a lender of last resort and without deposit insurance that would have calmed nervous savings account holders, this tiny bank run was the spark that led to contagion (a fancy word economists now use for widespread fear).

Fear Spreads
Other depositors around New York City wondered if their own deposits were safe, and like Lehman in 2008, the panic spread when a much larger organization suffered its own “no confidence” vote. Just two days later on October 18th, 1907, news broke that the president of one of the largest trusts in New York (The Knickerbocker Trust) was an associate of Heinz, and people all over the city began to question the safety of their deposits.

It was a classic run on the bank – fear begat more fear, and everyone wanted their cash back at once.

Trusts in New York at that time were not technically banks, but they acted just like them – taking in deposits and making loans. The problem was that these trusts were not regulated. Trusts made riskier loans, such as uncollateralized loans to stock brokers, who then used that capital to lend to their customers who bought stocks on margin. The trusts also had much more leverage. Banks in those days kept around $1 of cash in their vault for every $4 of deposits. At the trusts, each $1 of reserves was stretched across every $20 of deposits.

This meant that the trusts were much more vulnerable to runs. A trust could become insolvent if only 5% of its deposits were redeemed. In those days, with the right amount of fear, that could happen in an afternoon. And in October of 1907, it didn't take much longer than that to cause the failure of the Knickerbocker.

Around that time, a group of bankers, led by J.P. Morgan himself, were going over the Knickerbocker’s books, to determine whether or not it should be saved. In the end, the bankers, who were essentially acting as a central bank of sorts, decided to let the Knickerbocker go down (technically, the trust didn’t fail, it just closed its doors for six months and locked out depositors, but practically speaking, it was bankrupt).
The Knickerbocker failure sparked massive fear all around New York, and the contagion quickly spread to other banks, and even larger trusts. Morgan and his cohorts realized they may have made a mistake, and quickly reversed course by extending a lifeline to The Trust Company of America and a few other major financial institutions in the city.

This may have mitigated the worst possible outcome, but just like in 2008, the bailouts didn’t stop the crisis from spreading. Depositors continued to ask for their cash back, and the banking reserves of the entire financial system rapidly evaporated. An astonishing 48% of the deposits left New York trusts and found safety in mattresses and dresser drawers.

The panic eventually spilled over into the broader economy. Businesses didn’t have enough cash to finance their operations or pay their workers, and many had to close their doors and halt production lines. The stock market plummeted 40%.

Economic devastation has real consequences and it’s never fun to read about the plight of those who feel the effects most acutely. But from a human behavior standpoint, the Panic of 1907 is a fascinating sequence of events to read about.

Financial Panics Rhyme

As a side note, the similarities between the Panic of 1907 and the crisis that occurred 101 years later in 2008 were remarkably similar. Heinze’s bank failure was like Bear Stearns – it was the first domino, but on its own it should have been manageable. But the Knickberbocker – just like Lehman in September of 2008 – was the catalyst that accelerated the crisis and nearly brought down the financial system. In both instances, the men in charge (Morgan and his syndicate in 1907; Bernanke and Paulson in 2008) decided against saving what turned out to be a systemically important bank. And in both cases, this decision led to panic, crashing
stock prices, and additional bank runs. Everyone wanted their cash in hand. Both bank failures also caused the decision makers in each case to reverse course and save other teetering institutions – in 1907 Morgan saved the Trust Company of America, and in 2008 the US government saved AIG.

In addition, before the bailouts in 1907 and 2008, both groups of bankers were concerned about propping up doomed banks. Prudent lending was the concern in 1907; moral hazard was the concern in 2008. But ideology quickly was tossed out the window, and the focus became the practical matter of putting out the fire – the financial system had to be saved.

The Aftermath – The More Things Change, The More They Stay The Same...

The aftermath of both crises unfolded in a similar way as well. In both cases, the run on the bank created further panic, people demanded cash above any other asset, liquidity dried up causing businesses that relied on credit to suffer, which caused a broad economic downturn. (One difference is that the 1907 recession was very deep, but the recovery was swift, unlike the aftermath of 2008). The political aftermath was very similar between the crises as well. As is the case with most crises, Congressional leaders of both parties got on their collective populist and moral high-horse and dragged business leaders to Capitol Hill, demanding an explanation for what went wrong.

The general result of every crisis is always the same: after the finger pointing is finished, the remedy is new legislation and increased regulation – all designed to prevent the next crisis. Sometimes, this post-mortem results in sensible reform. 1907 gave us the Federal Reserve Act, at the time a wildly controversial piece of legislation that was viewed as a vast overreach of government power, but one that has proven to be a necessary linchpin to our financial system. The Great
Depression gave us the FDIC and the SEC. And the most recent crisis gave us Dodd-Frank and the CFPB. The merits of any of these could be debated, but I think it’s really interesting to study the common denominators and the human behavior aspect of all of these crises.

Given the fact that human nature doesn’t change, the next crisis is inevitable. Laws and regulation can be effective at times at preventing what caused a previous crisis, but greed and fear are two constants in financial markets, and they will be the two key ingredients that will lead to the next great crisis. The cause will be different and unexpected, but the human behavior before, during and after the panic will look very similar.

**Practical Takeaway**

From a practical standpoint as an investor, I think it’s always interesting to study the various financial crises that have occurred throughout market history. Reading first-hand accounts of these events as they unfolded gives you a great sense of how much asset prices can be impacted by sheer emotion and herd behavior. This is obvious to most of us, but it’s helpful to keep in mind, as even the most level-headed investors can be influenced by fear.

It’s also helpful to remember that the greatest investors are usually the ones who capitalize on such panic. Morgan was making loans when no one else was in 1907, and acquiring assets on the cheap. Buffett was providing capital and buying stocks when very few others would in the midst of the panic in 2008 (and coincidentally, J.P. Morgan’s eponymous bank would also be buying cheap assets 101 years after he helped save the system in 1907). Just like some of the banks in Morgan’s 1907 syndicate that came out of the crisis in a stronger position than when they entered it, some of the best companies in today’s world actually added to their intrinsic value because of 2008 (Berkshire and JPM are just two
examples – extending credit and buying companies when few others had the means or will to do so).

**One good lesson here is that it’s important to own stocks of companies that can take advantage of crises rather than be at the mercy of them.** Even if you are fully invested and all the stocks in your portfolio decline, if you own shares of businesses that can capitalize on the meltdown, the intrinsic value of your portfolio will increase (and stock prices will eventually catch up with that value). Almost every crisis turns out to be an incredible opportunity for those who can think clearly and make rational decisions.

Again, “being greedy when others are fearful” is one of the most obvious and most widely-repeated phrases in investing. But it’s easier said than done, and studying these crises gives you a sense of why that is. Human nature is a very powerful force that impacts us all.

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