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MAS071902

From Irrational Exuberance to Infectious Greed: the Confidence Crisis

The trashing of equity values in recent weeks, and in particular, the beating taken by equities this past ten days reflects a widespread **crisis of confidence**. Markets have lost confidence in the transparency of financial statements of public companies and, in many cases, and the ethics of corporate management responsible for for producing those statements. In the hearings last week, Greenspan spoke of the absolute need for transparency in financial statements because without it, trust is undermined, and trust is essential for the working of capital markets. Trust breaks down when misinformation becomes widespread. The question for Greenspan is why the "many bulwarks safeguarding appropriate corporate evaluation" broke down?

"Why did corporate governance checks and balances that served us reasonably well in the past break down? At root was the rapid enlargement of stock market capitalization in the latter part of the 1990s that arguably engendered an outsized increase in opportunities for avarice. An ***infectious greed*** *seemed to grip much of our business community."* (Allan Greenspan –Monetary Policy Report to the Congress-July 16, 2002, **emphasis added**).

Pounding on infectious greed as the source of our current problems is good politics, no doubt, but it is a dubious kind of economic analysis. Haven't greed (along with fear) always been a part of the ups and downs of markets? Is infectious greed the root problem on which our highest public officials should be focused? Is **infectious greed** a new explanation for our financial bubble?

Explaining the Bubble: From Irrational Exuberance to the Productivity Miracle

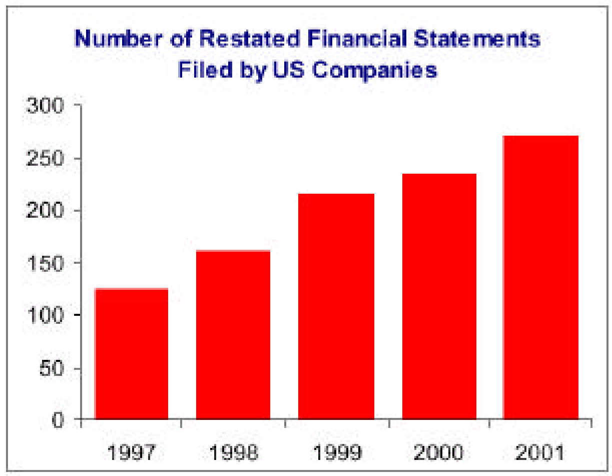
Greenspan is famous for espousing a new economic theory to explain current cyclical wrinkles. Midway into the Long Boom (1996), he introduced the public to **irrational exuberance.** Then, as equity markets continued to rise, he moved away from irrational exuberance and made rising productivity the centerpiece for explaining even higher equity values during the expansion of 1997-2000. The market reacted sharply to his December 5th 1996 speech with the Dow falling to 6381.94, down some 86 points from its December 5th close of 6437.10. A mere 86 basis point decline today would hardly draw a comment, but those were different times. From the day "irrational exuberance" became part of our permanent financial vocabulary, the Dow subsequently rose to 11722 (January 14, 2000). Since then, the DOW has fallen a hellish 32%. The NASDAQ, which surely had much more exuberance than the Dow, rose to 5048.62 (March 10, 2002) and has since imploded some 3729 plus index points or 74%. With productivity continuing to rise, but equity values drastically falling, here comes **infectious greed.**

The Confidence Crisis: The giddy ride to growth during the Bubble now appears to have been enhanced by the largesse of "**earnings manufacture**." The manufacture of earnings can occur in many ways. It can involve marking up assets (which we have seen) and/or marking down or eliminating liabilities (often through special finance organizations). Not all of the manufacture went undetected and write-downs and restatements of earnings were not uncommon! The graph below depicts those restatements, although it is not "scaled." Still, the graph makes the point. Lots of corporate earnings had to be restated. The graph only goes through 2001 but in 2002, 'earnings restatement' became a runaway train. There is great suspicion in the market as to how much more accounting fraud remains to be discovered and earnings restated.

We don't know how many dollars of earnings were 'restated." The data in the graph appear to be on an incident basis. Yet, only in 2002 has the confidence of American accounting practices become widespread. Greenspan explains how the "system" broke down as a financial epidemic   infectious greed.

RESTATEMENT OF FINANCIALS

The Huron Consulting Group's measure of restated financials filed by US companies shows a clear upward trend over the past five years. With corporate accounting standards under the gun and the August 14th SEC filing deadline quickly approaching one wonders if increased restatements in 2002 will lead to cleaner balance sheets in the future.



Courtesy: ISI 071902

The manufacture of earnings has been detected by internal, external and/or governmental processes. The recent plethora of restatements has been interpreted as a crisis of confidence, but Greenspan's couples his infectious greed hypothesis with the assertion that this epithet applies only to 'some,' not all managers. But why should infectious greed be an explanation for a Bubble? Bubbles have occurred many times before. Does it mean that 'infectious greed' is only around when a Bubble occurs? Is every manager a bad apple, or is this just another form of the "agency" issue, as Greenspan himself recognized.

Managers are, after all, custodians for the true owners of the corporation, the shareholders. Agency theory points to the inherent conflict between these two sets of stakeholders. Conventional wisdom claimed that having managers hold stock in the companies they ran resolved the conflict. That will work as long as the quality of earnings produced by the managers are the same kind of earnings that shareholders require as reward for the capital that they provide for the corporations. **Earnings quality is the issue and the policy problem is which participants in the capital market are responsible for the continual verification that the quality of earnings reported is "suitable."**

The Policy Issue

Greenspan holds the view that managers being rewarded with shares or options is a fundamentally sound idea, but managerial stock holding became a problem when the harvesting of stock gains by managers became excessive. A more careful consideration suggests that infectious greed can only be a problem if the earnings are really not representative of the corporations' future earnings production capability. It is this lack of transparency (mispricing) that can lead to the "timing" of the sale, so that the manager is somehow taking advantage of the mispricing of a security within a finite time horizon. Mispricing occurs precisely when the "current earnings" picture is not sustainable.

Sustainability is the essence of the discounting process and earnings quality is all about sustainability. Policing that sustainability is what the Capital Market is supposed to do. It is supposed to assess the quality of earnings and their sustainability to existing and potential shareholders and debt holders. According to Greenspan, the bulwarks failed.

Did American ethics really deteriorate or was it the plethora of wealth garnering opportunities and the failure to discipline the quality of the earnings that managers reported? And if discipline is required, it is required by corporate boards, stock exchanges, auditors, rating agencies, government agencies and shareholders themselves. Did each of these bulwarks break down simultaneously?

Some companies did practice discipline, reporting their earnings in a fashion that allowed the market to opine on their sustainability. **And, as we now know, some did not**. The real issue is that all of the above participants in and regulators of the capital market failed. They all got caught up in the Bubble. By definition, a bubble arises because it is filled with gas that is lighter than air. That makes the Bubble grow. All the participants inhaled and inhaled deeply. All of this is plausible, but it may not be right.

Greenspan was right when he talked about irrational exuberance, but he should have painted with a broader brush. Too many capital market participants inhaled the gas of exuberance. Our crisis is currently posed as either the result of a "few bad apples" or as the result of an inherent flaw in our system. Neither theory will stand up to closer inspection. Yes, indeed there were a few corporate managers who greedily harvested their stock options in a fashion that has undermined confidence in earnings transparency. However, the real issue is why so many capital market participants failed at perceiving the sustainability of earnings and what to do about it?

Producing transparent earnings has become a public good. Everyone in the Capital Market wants earnings transparency (or so they say), but the 'default position" is an unwillingness to pay and to continue to allow corporations to hire and police their own auditors. This puts the auditor in a suspicious light. This is clearly an incorrect solution to the 'public goods' character of earnings transparency, but the Capital Market has not learned how to price the process of producing solid numbers that will allow the market participants to determine quality and sustainability. Is this **infectious greed** or inappropriate pricing of a public good?ss

According to Greenspan, Corporate America's managers sensed that they could indeed "harvest" some of those stock market gains. The question for policy makers is how to make all of the owners, private and public know how large the harvest really is and when harvest time is going to occur! How to do that is the essence of the policy problem. It requires strong political leadership.

The current solution to the problem is the August 14th deadline by which the senior officers of the corporation will sign a kind of "loyalty oath" as to the reliability of the company's financial statement. This is to be augmented by legislation to punish offenders. Is this a suitable solution? Or, absent a decisive element of political leadership, will markets get into an increasingly difficult position? They already have, and it could get worse. What if Congress begins a vendetta against the 'bad apples?" Where will it stop? Markets cannot deal with Uncertainty. They do better when the Worst is in the past tense. Right now, we are unsure of the tense.

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