Chapter 1

What Just Happened Here?

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If you have ever woken up in the lemur cage at the zoo—and who hasn't?—you know that most true disasters start innocently enough. In this case, it all started with a night out with your buddies. You drank. You talked. You ordered a martini. It tasted good.

Pretty soon, someone suggested moving to Snickenfelder's, where they have a list of martinis longer than the menu. Good idea! After all, Snickenfelder's was just down the street. And when you got there, you were confronted with more alcoholic concoctions than you thought possible. You tried an apricot mango martini. Yum. An orange chocolate martini. Wow. On reflection, your mistake was ordering the Snickenfelder Schnocker, made with vodka, hazelnut liquor, amaretto, Irish cream, Kahlua, and more vodka.

You vaguely recall the karaoke contest, but you have to admit that you probably did not understand the rules when you got up on the stage. "Unbroken Melody" was probably a bad choice, given your state. At any rate, here you are, covered in peanut butter and surrounded by cooing primates.

In March of 2008, the world markets woke up with one of the ugliest hangovers in history. Bear Stearns, the fifth-largest U.S. investment bank found itself in the financial equivalent of the drunk tank: Sequestered with federal regulators and pitiless bidders for the remnants of its assets.

It was a nasty, nasty, bender that put Bear Stearns in the lockup, the sort of sudden decline that smacks of Victorian morality tales. Just two years earlier, Bear Stearns was a titan of finance, happily ensconced at its massive $1.3 billion headquarters at 383 Madison Avenue in New York. It had thousands of employees working around the globe, billions of dollars in assets, and a varied business in stocks, bonds, derivatives, and financial counseling for the very rich.

In short, Bear Stearns was a very big, very important company, one with tremendous earnings and global clout. And Bear Stearns remained a very big, very important company right up until the second week of March, 2008. On March 7, 2008, the company's stock closed at $70.08—well off its 2007 highs, but nearly every financial stock had been clobbered in 2008.

The next trading day, Monday, March 10, the stock slid more than 10 percent and closed at $62.30. Tuesday, it fell to $55. After a slight rally on the 12th, it slipped below $60 again. Then, on Friday, the stock collapsed, plunging to $30 a share. But the worst was yet to come.

Late on Sunday, March 16, word came out that arch rival JPMorgan Chase had bid just $2 a share for Bear Stearns, and

the company had accepted it. By the end of trading on March 17, 2008, Bear Stock was trading at $4.81 a share. The $2 price tag was just too low for Wall Street to believe—and rightly so, as it turned out.

"*JP Morgan Bags Wounded Bear—Bargain-basement $235 million for Reeling Giant*," read the March 17 headline of the *New York Post*.[1] JPMorgan Chase bought all of Bear Stearns for about a fifth of the value of its Manhattan headquarters alone. Later that week, bowing to threats of lawsuits, JPMorgan Chase upped the Bear bid to $10 a share—still, on its face, a tremendous bargain.

By the end of the Bear Stearns saga, there were plenty of ruined investors. Employees who had kept money in Bear Stearns stock were essentially wiped out. (Top management, who had many more shares, fared far better than the rank and file). But big companies fail all the time and, to be honest, they leave little mark of their passage, except for the holes they leave in the lives (and retirement accounts) of their workers.

When Bear Stearns collapsed, however, it nearly crippled the short-term money market, the lifeblood of modern finance. Bank lending ground to a halt. Municipal financing, which pays for roads, schools, and other daily essentials, evaporated. The company's fall changed the way the government regulates Wall Street, and it shook the faith of investors to the core—and justifiably so.

The Herd on the Street

How did it happen?

Periods of intoxication generally begin with sobriety, and it is the nature of manias that they start out perfectly sane. So we are going to detail, in the next chapter, the relatively sober

beginnings of the bubble that eventually bagged Bear. As you will see, things made a great deal of sense.

From 2005 until August, 2007 was the period of pure mania. Most of us are familiar with the boom in housing, but it is still interesting to recap, if only for sheer, eye-popping detail and *shadenfreude*. We will visit a small, somewhat representative town in suburban Washington to illustrate what soaring house prices can do to otherwise sober citizens.

But the real bubble—the one that took down Bear Stearns—wasn't in the real estate market. It was in the debt market. We think of bonds as a kind of investment for Old Money, the folks who would visit the bank vault every few months, clip a few coupons, and redeem them for walking-around money.

In fact, the bond bulls had run on Wall Street for a very, very long time. The bull market in stocks ran from August 1982 and ended (according to some views) in March, 2002, propelling the Dow up about 1,200 percent. (See Figure 1.1.)

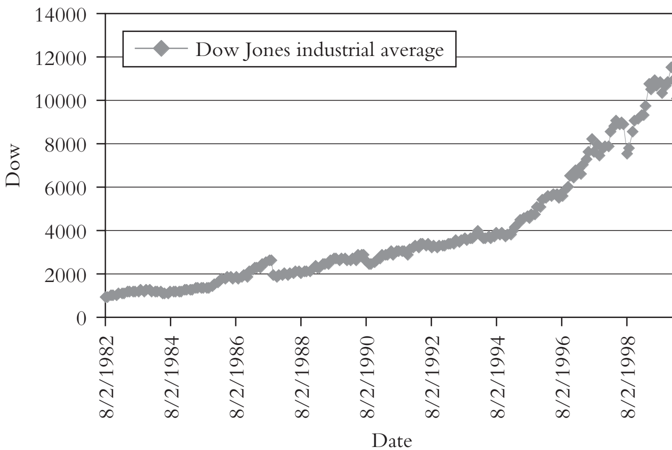

Figure 1.1 The Super Bull Market in Stocks, 1982–2000

But the bull market in bonds ran far longer. We will explain this in detail in Chapter 3, but bonds prices rise when interest rates fall. The yield on the bellwether 10-year Treasury bond fell from a high of 15.83 percent in September 1981 to a low of 3.35 percent in May 2003. For the past 10 years, you would have made far more money investing in bonds than you would have investing in stocks. (See Figure 1.2.)

We haven't seen a bear market for bonds in many, many years—and what brought down Bear Stearns was not the stock market, but the bond market. Bear Stearns nearly went bankrupt because the bonds it packaged and sold to investors were so incredibly bad. Eventually, Bears' creditors suspected that the company's assets were virtually worthless—and lending to a company with worthless assets is simply throwing good money after bad. At the very end, when Bear Stearns could not even get short-term lending, the company was forced to a

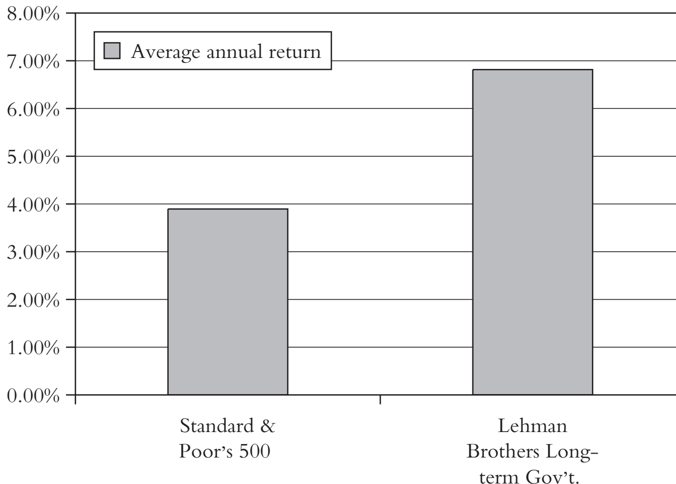

Figure 1.2 Stocks vs. Bonds, 10 years

great reckoning in a small room—the sale of itself for the fire-sale price of $2 a share to JPMorgan Chase.

Bear Lessons

The question, then, becomes what does the bear market in bonds and the demise of Bear Stearns mean for your investments? We can start with a few calming observations: For one thing, the system worked. We are not in a worldwide depression, the banking system is still functioning, and people get up and go to work every morning. The Federal Reserve did its job, and with some alacrity, too. All that's for the good.

Once that is settled, though, we have to ask a few questions about how we save and invest. We must, of course, assume that somehow the world will muddle through. Otherwise, we may as well hunker down in a bunker, eating canned food, and cradling our rifles.

For that reason, your core plan for investing—using a mixture of stocks, bonds, and money market securities to meet your goals—should not be radically different. We're not going to suggest you throw out decades of financial research and put all your money into gold or plastics or Irish punts. And in Chapter 5, we will give you some guidance on how to set up your basic plan of attack.

That said, we should also note that the world economic system is increasingly complex and precarious. For example, the use of derivatives among financial institutions is soaring. These are legal contracts between two parties: Their value is derived from the movements in various market indices, which is where the word "derivatives" come from. Currently, there are

about $55 trillion in derivatives outstanding, which is roughly five times the value of all the goods and services produced in the United States each year.

Warren Buffett, CEO of Berkshire Hathaway and the world's wealthiest man, knows a thing or two about risk. He had this to say about derivatives in 2007:

> I believe we may not know where exactly the danger begins and at what point it becomes a super danger. We don't know when it will end precisely, but . . . at some point some very unpleasant things will happen in markets.[2]

As investors, we have other worries, too. The U.S. debt now totals $9 trillion, close to a record in relation to our gross domestic product. The Treasury's credit rating is the world's gold standard. In times of crisis, in fact, people buy Treasuries, not gold, even though gold has been the world's fallback currency since Nebuchadnezzar was in short pants.

Unfortunately, we are not working earnestly to repay those debts. We're adding merrily to them, to the tune of $2 billion a day. A billion here and a billion there, as Senator Everett Dirksen once said, and pretty soon you're talking real money.

Even worse, the U.S. doesn't save enough of it to count on the public to buy them. It has to rely on other governments to buy our daily $2 billion of Treasury securities. So far, that has worked just fine—although it has put a great deal of pressure on the U.S. dollar. Should other countries say one day, "Thanks, we just need $1.5 billion today," then the dollar could quickly fall from the gold standard to the silver standard. (See Figure 1.3).

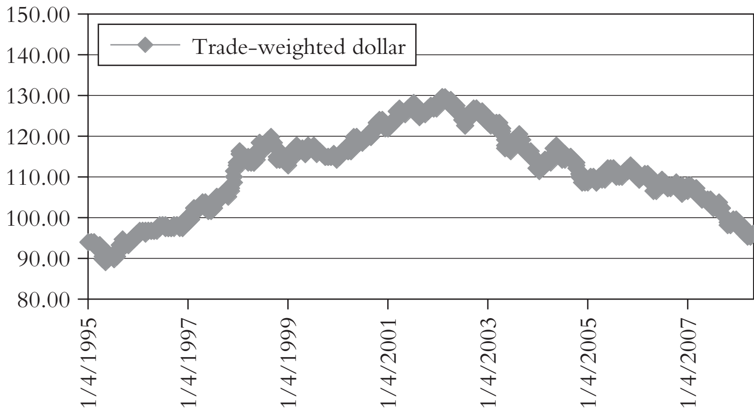

Figure 1.3 Trade-Weighted Dollar Index

Investors, then, need to take a few precautions against catastrophe. One potential catastrophe is debt liquidation—the type we came perilously close to seeing when Bear Stearns collapsed. Debt liquidation simply means cascading defaults, which will ultimately lead to a Depression-like economic downturn. There are some schools of thought that this kind of event—which occurred with depressing frequency in the 19th century—is actually good for the economy, a kind of economic cleansing process. These are the same kind of people who giggle during horror movies, too.

In Chapter 6, we will start with the most basic way to protect yourself from deflation: Paying down your debt. You may recall your grandmother warning you about the peril of debt. And you know what? She was right. It makes no sense to plan a portfolio that returns 12 percent when you are paying 25 percent to your credit card company.

Once again, let's not get carried away: Some debt is good. If you have a 6 percent mortgage and can afford the payments, then relax. That is cheap money—and you can probably earn

better returns elsewhere than what you would get from paying down your mortgage early.

Your portfolio, too, can be clobbered by deflation. Although some stocks might weather deflation well—nasty businesses like payday lending companies come to mind—you might be better off by adding some high-quality bonds to your portfolio. Think of it this way: If you get $100 a month from your bonds each month and prices fall, your bond becomes increasingly lovely in the eyes of other investors—and they will pay you a premium for it.

Another solution to our massive debt problem isn't much more palatable. If the government allows higher inflation, it can repay its debt with progressively cheaper money. But that means that the price of food, gas, and other essential rises too—which ultimately impoverishes everyone. Inflation has been called the cruelest tax, because it hurts those on a fixed income most—like people who live on pensions or periodic withdrawals from their savings.

Not too long ago, there was one hedge against inflation: gold. And it's still an inflation hedge, albeit one that's annoying to store and pays no dividends. But today you have several other options for fighting inflation, such as Treasury Inflation-Protected Securities, or TIPS. We will run through your inflation-fighting options in Chapter 7.

Finally, we must remember that booms and busts are part of the fabric of capitalist society. And it is fabulously easy to get caught up in the boom, and crunched in the bust. How can you tell if Wall Street has left the world of the rational and gone straight to the laughable? It is not easy, but there are signs, and good ones. We will talk about those in Chapter 8.

Kurt Vonnegut, author of *Slaughterhouse Five,* among other novels, once said that the only thing we can learn from history is to be surprised. He's quite right. Somewhere along the way, the people at Bear Stearns—and much of the rest of Wall Street—felt that there was nothing to be surprised about.

As an investor, you can make intelligent guesses about what the future will be like. But there will always be surprises. For that reason, you need to cast your net far and wide to protect—as best you can—against the unexpected. There will be days when your small insurance positions in foreign bonds or commodity funds will make you feel like the village idiot. That's ok. When you invest, making gains are just part of the game. The other part is keeping them. It is a lesson that Bear Stearns could have learned a little better.