

The Clued-in, the Clueless, the Oblivious and the Conflicted

By Michael Edesess
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I've now read perhaps 10 books about the financial crisis. Maybe I'm a junkie, but each has given me new information or a fresh way of looking at events.

“All the Devils Are Here” offers a treasure trove of information about company behavior during the crisis, notably Fannie and Freddie, Goldman Sachs, Merrill Lynch, AIG, Countrywide, and Ameriquest. It also adds to our information about Bear Stearns, Federal government agencies, and others.

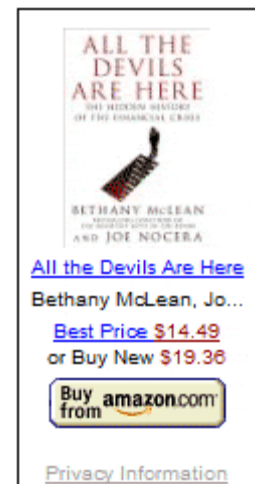
Some commentators on the crisis identify villains – individuals, corporations, institutions, government entities, or failures of the system itself. Some authors assert that certain would-be villains are actually blameless. Those held harmless presumably only acted as they must, given their incentives and the duties assigned them by their roles. The choice of whom to indict and whom not to indict often depends on the blamer’s visceral aversions – anti-government, anti-corporate, or anti-system.

McLean and Nocera are, by implication, equal-opportunity indicters. They make the government sponsored enterprises Fannie and Freddie on the one hand, and wholly private enterprises like Ameriquest, Merrill Lynch, and AIG Financial Products on the other, look pretty bad – not to mention the rating agencies, to which we shall come soon.

Some who blame government and by and large hold Wall Street harmless – including many on Wall Street – assume that regulated entities will do what government allows them to do. If the government doesn’t regulate correctly, what they do will not turn out well; if government regulates well – meaning in a laissez-faire manner, with favoritism toward none – things will turn out optimally. This view, labeled utopian economics by John Cassidy in his book “How Markets Fail,” still has many adherents.

Am I one of the few who believe that firms should heed a higher moral code than simply avoiding running afoul of the law? I’m not even talking about “corporate social responsibility” here, just what I think used to be called professionalism. Companies like Goldman Sachs probably once adhered to that credo, but it is now almost fully eroded.

A new candidate





I would like to nominate a new candidate for villainy: our idiotic preoccupation with brands.

Consider the following quote:

“The [financial] industry has changed the way people [think about money]. It has realigned our economic class system. It has changed the way we interact with others. It has become part of our social fabric. To achieve this, it has sacrificed its integrity, undermined its products, tarnished its history and hoodwinked its consumers.”

This is not actually a quote about the financial industry. Except for my substitutions, it is from the book “Deluxe: How Luxury Lost Its Luster,” by Dana Thomas, about the luxury industry. Thomas’s book describes how conglomerates like LVMH bought up luxury brands like Louis Vuitton and degraded their quality to make them more profitable, while blaring their brand names ever more loudly.

And buyers bit.

In the run-up to the financial crisis, people and institutions bought brand names like Merrill Lynch, Citigroup and Goldman Sachs, but they were deceived. These were once good brands; but in extending their services more broadly and focusing, laser-like, on profits they sacrificed their integrity.

When we believe fervently in brands, we never look under the hood. Meanwhile new ownership or new management can allow – or cause – the engine to degrade.

In “All the Devils Are Here,” Bethany McLean and Joe Nocera show the alarming extent to which Wall Street brand name firms were themselves enthralled by brands – the ratings agencies. When Moody’s and S&P rated a CDO triple-A, the firms believed the securities were virtually riskless. A quick peek under the hood would have told them differently, but they believed it anyway – even if they often connived in the rating themselves.

The belief in brand names is so enduring that Merrill Lynch is still Merrill Lynch, even after a bewildering series of newsworthy failures over recent years. Among these: advising Orange County, California, to invest in derivatives so risky that it drove the county into bankruptcy; loudly touting internet stocks while in emails confiding to each other that they were dogs; and, most recently, packaging and dispensing humongous quantities of extremely risky collateralized debt obligations.

You would think that Merrill Lynch, now under the receivership of Bank of America, would have at least changed its name – much as Philip Morris, of the disgraced tobacco industry, changed its name to the melodic Altria Group.

But no, a brand name is a brand name. Recognizable is celebrated. Celebrated is wealthy. Wealthy is admirable. All faults are redeemable when you’re a brand name.



Wall Street brand-name firms were flummoxed too

Perhaps Wall Street brand-name firms were primed for self-deception – they were, after all, making a whole lot of money by believing that what they were selling to suckers was riskless – but many of them, including Merrill Lynch, Bear Stearns, and AIG Financial Products, kept believing the ratings even after the game should have been up, and they dug themselves ever deeper into a hole because of it.

Those who didn't entirely buy the ratings didn't blow the whistle on them either. Tellingly, they were the companies that seem to be perpetually among the wisest. "Vanguard had stopped buying mortgage-backed securities in early 2006," say McLean and Nocera, "because they were less and less comfortable with the ratings."

Goldman Sachs also smelled a rat but didn't say anything to its customers or to anyone else. As McLean and Nocera put it, "If Goldman knew that a triple-A rating no longer meant what it once had – and that these complex securities carried far more risk than their ratings implied – did it really have no responsibility to say anything?"

Perhaps Goldman didn't say anything because doing so might damage its brand. How could it question such widely trusted ratings as those of Moody's and S&P? Such is the belief in brands that to question one is to risk one's own.

The clued-in, the clueless, the oblivious, and the conflicted

Many companies and government entities are covered more or less in-depth in McLean's and Nocera's book. The picture is different for each. Categorize them as the clued-in, the clueless, the oblivious, and the conflicted.

Among those clued-in were the political manipulators: subprime mortgage lender Ameriquest and government-sponsored enterprises (GSEs) Fannie and Freddie. Roland Arnall, the founder of Ameriquest, was so politically astute that at one point no less than Barack Obama defended his company in Congress.

Fannie and Freddie ruthlessly leveraged their political clout to gain governmental regulatory advantage, marginalizing their competitors, until the competitors discovered the subprime market from which Fannie and Freddie were barred – but then they too jumped on the bandwagon, not to be left behind.

Also generally clued-in, not surprisingly, was Goldman Sachs.

The story of Goldman Sachs, in McLean's and Nocera's telling, is the most tragic and most implicitly hortatory. Its relatively recent history begins with CEO John Whitehead, who in



1976 “set down a list of Goldman’s fourteen business principles. The first one began, ‘Our clients’ interests always come first.’”

In more recent history it becomes clear that Goldman violated this principle wholesale. Goldman makes its huge profits by taking full advantage of its asymmetric information advantage. To be so close to the center of financial dealings and so wired-in often puts the company in a position to gain from its position at the expense of its clients, which it does, amorally and pitilessly.

Clueless, or at the very best greedily oblivious, were Merrill Lynch, Bear Stearns, AIG Financial, and, it appears, most of the Federal government agencies and the financial industry self-regulatory bodies. Practically on the day when the game was up for Merrill CEO Stanley O’Neal, he was relieved of his illusions by former Merrill top risk manager John Breit, who had been pushed aside by the risk-takers.

In their belated interview, say McLean and Nocera, “O’Neal kept probing. What about the risk models? he asked. Worthless, replied Breit matter-of-factly. The risk wasn’t captured by VaR [the vaunted “sophisticated” risk-measurement system], and the VaR analysis of the underlying credit quality was wrong.”

What the clueless had in common was their belief in models and in the agencies’ ratings, which themselves relied on – or at least were justified by – models. Again it took John Breit – a former physicist who actually did know sophisticated mathematics – to see things clearly:

“Breit had also learned over the years,” say McLean and Nocera, “that, by the standards of a physicist, Wall Street was quantitatively illiterate. Executives learned terms like ‘standard deviation’ and ‘normal distribution’ but they didn’t really understand the math, so they got lulled into thinking it was magic. Traders came to believe the formulas were not an approximation of reality but reality itself.”

If you really were sophisticated and knew that the claims of sophistication were a sham, you got pushed aside. “Sophistication” is an essential part of the Wall Street brand.

The conflicted

There are two examples of the conflicted in the book – one obvious and one not-so-obvious.

Angelo Mozilo, the founder, CEO and patriarch of Countrywide, is a classic example of conflicted, or at least of two alternating minds. He wanted his company to hold the line on quality, and it did for a long time. But he was also obsessed with the idea that his company had to be first, and that was his – and his company’s – undoing. When Countrywide was in danger of not being first anymore, it began to lower its standards, in spite of all of Mozilo’s



former principles. He went with the deputies who favored lowering standards, and sidelined those who didn't – all apparently in the name of being first.

The second example of being conflicted is one that is not actually outlined in the book – the curious case of Chuck Prince, the former CEO of Citigroup. I draw my conclusion from the combination of a quote in McLean's and Nocera's book, with another quote seen incessantly in the press. It is a particularly interesting and perhaps enlightening case.

McLean and Nocera cite an incident in former Treasury Secretary Hank Paulson's memoir "On the Brink." In that memoir, Paulson describes a dinner in June 2007 with a handful of Wall Street chieftains, including Jamie Dimon of J.P. Morgan, Lloyd Blankfein of Goldman Sachs, and Chuck Prince, the CEO of Citigroup. "All were concerned with excessive risk taking in the markets and appalled by the erosion of underwriting standards," Paulson wrote.

At that dinner, Paulson said, "[Prince] asked whether, given the competitive pressures, there wasn't a role for regulators to tamp down some of the riskier practices. Basically, he asked: 'Isn't there something you can do to order us not to take all of these risks?'"

Chuck Prince, you may recall, was the CEO widely quoted as having said, "as long as the music is playing, you've got to get up and dance."

We see this quote everywhere, but I'm not sure we knew what it meant. In the context of Paulson's dinner, it clearly means, "We can't stop ourselves – can somebody please stop us?"

Notice that Prince did not direct his plea to those who Milton Friedman believed to be the ultimate arbiters of the quality of a firm's product: its customers. No, that would have terminally poisoned Citigroup's brand. He directed it instead to the highest government official of the financial industry. What does that tell us?

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