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## **What Went Wrong and What's Next?**

Thoughts for you and your clients.

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If you're confused about what is going on in the world economy, you're not alone. Its confusing.

What created this panic?

In my opinion, two main blunders are responsible for turning what should have been a big correction within a normal market into a panic that created a bear market. The first force was the impact of an accounting rule change that forced financial companies to write-down their assets too quickly. This happened earlier and was the setup for the storm. The second element was the government's deliberate destruction of Wall Street as we know it. This was done in the name of rescuing the market but it has turned out otherwise. This second misstep has caused massive financial turmoil. This is what most advisors and investment strategists missed.

### **Accounting Rule Change**

Let's start with the first issue — accounting rule changes. Most financial firms borrow money in order to make profits. European firms were allowed to borrow a great deal more than American firms. In 2004, the U.S. Securities and Exchange Commission (SEC) changed the rules to allow our financial firms to borrow more so they could compete with European financial institutions. Of course, when you borrow more, you take on more risk. And you may or may not recall, but during that period, the government was actively encouraging these same companies to loan more money to lower quality borrowers. Congress and presidents like to boast about how they've expanded home ownership during their tenure. So taken together, this meant the financial firms were taking on vastly more risk.

While they were making more risky loans, these financial companies became very sophisticated. They found ways (credit default swaps, collateralized debt, etc.) to take on more debt without appearing to take on more risk. If it sounds impossible you are right. The risk didn't magically disappear. Also, these "sophisticated" tools were illiquid and hard to value.

In November 2007, another new accounting rule was put in place. It forced the companies who created these illiquid investments to reflect the daily market value of these investments on their books. To understand the impact of this, let's illustrate with an example.

**Example:** Suppose you own a piece of raw land. You go to a bank to borrow money and they want to see your balance sheet. On your balance sheet, you show the value of the land if it were sold in an orderly fashion. The bank says no. They tell you that if you want the loan, you have to show the value of the land as if you had to sell it that week — at fire sale prices. It's tough to sell raw land — it's not liquid. Obviously, under these conditions, your balance sheet would look terrible because you'd have to show the land at a much lower value. As a result, the bank refuses to lend you the money. This is what happened to many financial service companies. They couldn't get loans so they couldn't stay in business.

This accounting change created a spiral of financial companies writing down assets leading to lower and lower prices for those assets. This is one of the reasons that Bear Stearns and Lehman Brothers are now on the ash heap of history.

This explains the first problem.

### **Helping Commercial Banks**

The second problem was created by Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke in my opinion. In order to deal with the first problem, they made deals that helped commercial banks at the expense of nonbanking firms. It's very complicated and I don't want to go through all the details here. I don't believe this was done with malice. But the result has been chaos and panic.

Bernanke's primary job responsibility is to protect banks and that is what he did. The banks manufactured many of the "sophisticated" loans I spoke of earlier. The Chairman simply safeguarded the banks that created these investments at the expense of the nonbank financial institutions who in essence bought them.

He took sides with the banks at the expense of the investment houses.

Did you notice that Merrill Lynch sold itself to Bank of America overnight? Did you notice that Goldman Sachs and Morgan Stanley petitioned to become federally-chartered banks? Why? Because these firms knew that if they didn't become part of a bank, they would meet the same fate as Bear Stearns and Lehman Brothers.

Without being political, I will tell you that the government hasn't been the solution to this problem. They got out a loudspeaker and told the world who not to lend to and this sealed those firms' fate. Again, they probably think that what they did was the right thing to do. But they created the panic. They eliminated Wall Street as we know it in a just a few short months.

### **Why Didn't Anyone See This Coming?**

A few people did. Most of those who did "predict" this were the people who are always bearish.

But the reason that few people did recognize what has happening is that nobody has ever seen an extended panic before. Sure we've had bear markets and recessions, but not a panic like this one.

Bear markets happen every three to five years. They are common. Panics aren't. In fact, the closest comparable panic was in 1987. But it was very fast and it wasn't a bank panic. You may never see another broad market panic during your life. In fact, they are so rare that it is very hard to model an investment strategy to account for them.

### **How Do You Recoup Your Losses?**

What do we do from here? What is the strategy to recoup losses?

The first thing to do is remain calm and not panic.

What we have right now is pessimism at an unprecedented level. That's usually the worst time to sell everything. Stocks have historically delivered very strong returns in the periods after panics. I have no reason to think this will be any different this time. Even if I'm wrong in the short-term, I feel it's the correct thing to do in order to be consistent with your long-term goals.

The bottom will come. Maybe it was yesterday. Maybe it will be next week. Next month. Nobody knows. It may be further away. Because of the severity of the panic, I believe it would be a major error to sell everything now.

Of course, there are alternatives. Your clients could sell everything, put their money in certificates of deposit (CDs) and never invest again. For almost any of your investor-clients, that would probably mean they would never reach their financial goals.

Another idea is to sell everything now and wait for the market to strengthen before re-entering the market. Since historically, the market rebounds when pessimism is at its height, that course of action carries great risk and makes no sense to me.

### **Conclusion**

There are no quick fixes.

In conclusion, many experts have suggested a number of steps the government could take to remedy the current problems. Eventually, I think these steps may be adopted. Either way, we will survive this as a country and as investors.

We are in the middle of a bubble of pessimism. Everything is seen as bad. When the House didn't pass the bailout package, the market fell. When the House passed the bailout package, the market fell.

Yes, we are in a market panic. But what is important now is for you not to panic.