AUTHOR OF **BUFFETT** AND **WHEN GENIUS FAILED**

ROGER LOWENSTEIN

"A crucial account of an era of excess and folly . . . riveting . . . will only seem fresher with time" —*BusinessWeek*

ORIGINS OF THE CRASH

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The Great Bubble and Its Undoing

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Praise for *Origins of the Crash*

"So is it safe to buy stocks again? After you read Roger Lowenstein's *Origins of the Crash* . . . you'll have serious doubts."

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"As a premier business journalist and author, Lowenstein has the chops to deliver what this book promises: 'the definitive account' of Wall Street's latest unraveling."

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"A wide-ranging examination of the stock-market boom of the 1990s and its resounding crash. . . . Are there lessons to be drawn? Yes, many."

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"If you want to feel discouraged, outraged, and simultaneously enlightened about the current state of the stock market and the corollary issue of corporate excess, turn to Roger Lowenstein's cynical and fascinating *Origins of the Crash*. Carefully and clearly, financial expert Lowenstein explains how the American financial system got to where it is today."

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"Someday, students of American business history may tear open *Origins of the Crash*, Roger Lowenstein's latest book, to learn why the last decade's bull market came to an ugly end nearly four years ago. . . . An intelligent look at what ails America's corporations. . . . Mr. Lowenstein is at the top of his own game."

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"The ingredients are familiar: executive overcompensation and stock options, irrationally exuberant shareholders. . . . The author juxtapose[es] them so brilliantly that the twenty-year history that inflated the bubble seems not just understandable but inevitable. . . . Lowenstein's low-key ease with the most complex financial reporting makes this book both accurate and easy to read."

—*Publishers Weekly* (starred)

"Roger Lowenstein is a rare commodity: a financial journalist with no apparent ax to grind, who seems to understand the people and institutions he covers and is more often right than wrong on the big issues that matter. . . . In short, it would be hard to pick a better candidate than Mr. Lowenstein to sum up the broader lessons of the most recent boom and bust."

—Jonathan A. Knee, *The New York Observer*

"With the benefit of hindsight, it appears unbelievable that so many people, including presumed market experts, could have been wrong about so much, that such huge sums of money could have simply vanished in crazy-seeming speculations. How could this have happened? A comprehensive answer can be found in Roger Lowenstein's *Origins of the Crash*."

—Paul Gray, *The New Leader*

"A former *Wall Street Journal* reporter and the author of bestsellers about Warren Buffett and long-term capital management, Lowenstein blends detail and drama in a colorful, fast-paced narrative."

—Steven Brull, *Institutional Investor*

"Lowenstein opines with grace and intelligence . . . in his litany of wrongdoing, Lowenstein raises a startlingly basic idea—the new products and techniques that Wall Street was infatuated with had little connection to corporate profitability. . . . And so, in the end, much of the Internet effect was 'not to enhance profitability but to trim it'—a lesson that was all but lost on a euphoric and greedy Wall Street."

—Tom Goldstein, *San Francisco Chronicle*

"In *Origins of the Crash* Lowenstein steps behind the numbers to examine the culture that led to the creation and the bursting of the stock market bubble at the turn of the millennium. . . . Lowenstein tells the story of the bubble with authority, force, and just the right amount of outrage. It is a sobering tale."

—John P. Mello, *The Boston Globe*

"A fine writer with a gift for concision . . . Mr. Lowenstein captures the spirit of the era." —Russ Mitchell, *The New York Sun*

"*Origins of the Crash* by former *Wall Street Journal* reporter Roger Lowenstein masterfully dissects the late-1990s stock boom and how it came to be. . . . A crucial account of an era of excess and folly . . . will only seem fresher with time."

—Marcia Vickers, *Business Week*

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ORIGINS OF THE CRASH

Roger Lowenstein, author of the two bestselling books *Buffett: The Making of an American Capitalist* and *When Genius Failed: The Rise and Fall of Long-Term Capital Management*, reported for *The Wall Street Journal* for more than a decade and wrote the *Journal*'s stock market column "Heard on the Street" from 1989 to 1991 and the "Intrinsic Value" column from 1995 to 1997. He is now a columnist for *SmartMoney* magazine and writes for *The New York Times Magazine* and *The Wall Street Journal* among other publications. He has three children and lives in Westfield, New Jersey.

To Judy

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This book is somewhat changed from what was planned at the outset; indeed, the original intent may be unrecognizable in the finished work. Through all of the readjustments that this entailed, my agent, Melanie Jackson, retained—or at least projected—her continuing faith; to her, I owe my gratitude as well. The change in my focus—I began the project before the collapse of Enron and so many other developments in the corporate sphere—may obscure the contribution of many people who generously agreed to be interviewed before the project's redirection. Their help is appreciated nonetheless. Finally, my editor, Ann Godoff, was indispensable in helping to set this book on its proper course—indispensable and irreplaceable. To her, more than ever, my acknowledgments and my thanks.

"Set our course by the stars,
not by the lights of every passing ship"

—OMAR BRADLEY

Origins
of the
Crash

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ONE

Origins of a Culture

In the 1970s, a candidate for president advanced the novel proposition that the money in the Social Security system should be funneled into, of all places, the stock market. The candidate's name was Ronald Reagan. The incumbent president, Gerald Ford, had a good deal of fun with this evidently zany proposition. "I am not sure a lot of people would think it was a very good place to invest funds over the longer period of time," Ford declared.[1] His advisers had no trouble tarring the idea as kooky. The president likened it to "something dragged out of the sky." If not certifiably alien, then it might even be—perish the thought—an example of "wild-eyed socialism," which was no doubt something worse.

Ford did not have to explain why he thought the stock market was not a safe place "over the longer period of time." Stocks were considered simply too risky. Indeed, in 1976, the market was no higher than its level of *eleven years* before. Adjusted for inflation, the picture was far worse: the purchasing power of the average stock had fallen by twothirds. Even over the longer sweep of a half century, stocks had managed a gain of only 3½ percent a year, so that people thought of the stock market as a place that went upwards a little but sideways mostly, with wrenching nosedives along the way. Indeed, the number of Americans who owned stock would actually fall during the '70s by seven million.[2]

Such grim statistics were reflected in a certain distance between the market and people's ordinary lives. Most newspapers carried at most a single account of the previous day's action on Wall Street, and television barely covered it at all. Today, at my daughter's middle school in New Jersey, an investing club is busily educating future market wizards, but in the '70s, through four years on an Ivy League campus, I didn't hear a mention of the stock market. Professors spoke darkly of America's "economic interests," but if any of those interests happened to be corporations with publicly traded shares, it was a detail that went unspoken.

Unlike in the '90s, when people would become accustomed to faithfully adding a little bit to mutual funds, rain or shine, every month, in the '70s, they *withdrew* a little bit, month after month, and they did so for eight long years. For Wall Street it was one long night, one long depression. Even the pros who managed pension funds were little more interested in stocks than my professors were. By 1979, of the money managed by pension funds, 90 percent was invested not in stocks but in bonds, bills, and cash, which was practically like stuffing it under a mattress.[3] That summer, *BusinessWeek* sized up America's non–love affair with the stock market in a morbid, instantly famous cover story—"The Death of Equities."[4]

But equities were not dead, only dormant. And the renaissance began in short order. Three months after the article, mutual funds—finally—took in more money from investors than they redeemed. The net addition was a trifle—a mere $12 million. But deep in the giant furnace room where the economy is engineered, a long-stuck wheel had emitted a creak, shaken off its cobwebs, and, finally, turned. People were buying stocks.

Over time, this little shift, this rediscovered habit that ripened into a passion, affected far more than the Dow Jones average. When investors awoke, executives found that they, too, inhabited a different world. The rules soon changed for auditors and analysts and ordinary savers as well—an entire culture was retailored. By the late 1990s, America had become more sensitive to markets, more *ruled* by markets, than any country on earth.

This was the culture that led to prosperity and also to Enron. Markets became virtually sovereign—unchecked by corporate watchdogs or by government. Distortions followed, and with the temptation of wealth that distortions brought, corruption. But in the late '70s, no one was thinking of markets as powerful or pervasive. The country's problem was that it was too *in*sensitive, too *un*responsive, to markets. They were not hyperactive or feverish then but—potentially—a cure.

The bullishness and greed of the '90s had their origins in the very different environment of the '70s and, in some sense, much earlier. The financial culture had for most of the twentieth century suffered from a deficiency in what is known, rather antiseptically, as corporate governance. Since most executives owned no more than a nominal amount of stock, their interests were less than precisely aligned with those of the stockholders. It is no wonder that many a corporate CEO took home a large salary and enjoyed the perks of "success" even while his stockholders grew poorer.

Of course, the CEO was nominally supervised by the directors. But the typical board was larded with the CEO's cronies, even with his golfing buddies. They were generally as independent as a good cocker spaniel. It is true that textbooks spoke of shareholder democracy and that, in theory, the shareholders could vote the directors out. But proxy challenges virtually never succeeded—indeed, they were rarely attempted.

The electoral mechanism was too cumbersome and management's advantages too numerous. Some other means was needed of holding managers' feet to the fire.

This had been evident in a crude sense since the 1930s, when Congress held hearings into the roots of the great market crash, and it was in the '30s that the basic rules for protecting investors were put in place. A string of scandalous revelations had left a clear impression of Wall Street as unsavory and, indeed, untrustworthy. In one episode, the National City Company (a predecessor of the present-day Citigroup) peddled foreign bonds, issued by Peru, to naïve investors while concealing from the public information that left no doubt as to the dubious nature of Peruvian credit. "No further national loan can be safely issued . . ." wrote the bank's agent in Peru, all the while as its salesmen in New York were lustily hawking three distinct issues of Peruvian bonds.[5] And there was widespread evidence that, during the 1920s, stocks had been secretly manipulated by powerful insiders. The most notorious was Albert Wiggin, president of Chase National Bank, who, without bothering to inform his shareholders, was privately dealing in his own stock and, indeed, helping to drive it down.

In retrospect, it is startling how similar these stunts were to episodes of the '90s. National City might have been the Internet analyst of its day, and Wiggin was merely a harbinger of Dennis Kozlowski, the quick-fingered chief executive of Tyco International. So much recurred that one almost wonders if the government had adopted any protections at all.

But of course it had. The New Deal's response was extensive, but it can be summarized in one word: "disclosure." Legislation created the Securities and Exchange Commission as a cop on Wall Street, but the SEC could never have the manpower to go poking into every single company's files. Instead, the burden of preventing would-be Enrons, Tycos and WorldComs would rest with the companies and their auditors, who were now required to disclose all the material facts that an investor would want to know. The real policing would be done by *markets.*

The theory was that a CEO, knowing that markets were watching, would keep his hands clean. Disclosure was the least intrusive form of supervision—like a mother's telling her child to keep the cookie jar in plain sight. Or as Louis D. Brandeis had explained, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[6]

It worked, but only to a point. As long as a CEO made proper disclosure, a poor performance—even a poor record over a long period of time—generally did not result in his ouster. In other words, the requirement to disclose motivated a CEO *not* to do ill and generally not to violate the law, but it did not ensure that he would build value for the owners.

By the 1970s this had become painfully clear. CEOs such as Harold Geneen of International Telephone & Telegraph (ITT) had built huge conglomerates that, while enhancing their fiefdoms (and their regal lifestyles) had done precious little for their shareholders. Executives in industry after industry had been so complacent they did not see the oncoming freight train of international competition. Detroit saw its share of the world auto market plunge from 75 percent in 1950 to an abysmal 20 percent. At IBM, too, dominance bred smugness. So satisfied was the computer giant with the fat, 60 percent profit margins on its flagship mainframe that it was asleep to the tectonic shift unfolding in computing, which dislodged mainframes in favor of the personal computer.[7] For some reason, at these and at many other companies, the market check—the need of executives to perform for their investors—wasn't working.

Not surprisingly, the generation that ran these companies had come of age after World War II, in an era of fixed exchange rates and government regulation. They were programmed for stability, not change—for gradual evolutions planned by managers, not for chaos wrought by markets.

But chaos found them anyway. By the end of the '70s, stocks had fallen far enough to scream "cheap." The values inherent in stocks inspired a new and distinctly American phenomenon: the hostile takeover. The phrase refers to the practice of acquiring a company over the objection of management. Instead of waiting for their intended to say, "I do," raiders simply asked the stockholders to tender (sell) their shares, though there was nothing tender about it. Most of the early hostile bids involved companies in the same line of business, frequently energy (Conoco Oil was a celebrated target). With prices so compelling, so the saying went, the cheapest place to drill for oil was on the floor of the New York Stock Exchange.

By the early 1980s, Wall Street had spawned a new occupational class: the raider or takeover artist for hire—the gunslinger without portfolio. Carl Icahn, Henry Kravis, Irwin Jacobs, and a host of lesser gunmen were financiers as distinct from operators; they went after whole companies in diverse industries, typically offering premiums of 30 percent to 40 percent above the market price. People's interest in stocks naturally began to revive.

Takeovers had a similarly energizing effect on managers, in particular on CEOs. Previously, theirs had been the safest jobs around; now, their fortress was under siege and their pulse rate was on the rise. Given the dreadful state of their companies, a little anxiety was no bad thing. To escape a buyout, CEOs felt they *had* to raise their share price. This was a significant departure. Previously, stock prices had been seen as a long-term barometer. Prices in the short term were notoriously unreliable (this was the lesson of the Great Crash). But with a Henry Kravis lurking, the long term might not exist. Or as John Maynard Keynes liked to say, in the long run we are dead. Now CEOs had to demonstrate that they (and