Of Bolshevism and Bear Markets

As the US House Energy and Commerce Committee expands its investigation into questionable accounting practices by publicly-traded companies, we're reminded once again that such inquests, like court rooms, are not so much about "right" and "wrong" as they are about placing blame. In the pornographic theatre of public opinion, good love may be hard to find, but celibacy is hard to take, so the requisite casualties will be delivered (many of them well-deserving, no doubt). Thankfully, CNBC is there to remind us that, lest we forget, Club Fed is no picnic. It's no gulag either, but then one man's prison is another man's low-tech fitness regimen.

Life in the Gray-Bar Hotel aside, how relevant are any of these prosecutorial efforts to the markets at large? The losses stemming from actual fraud are fractional compared to those triggered by the market pullback overall. Why even care, especially with the Dow back over 9100?

The customary refrain is that investors are willing participants in the US securities markets only because those markets are liquid, transparent and trustworthy. It’s more accurate to say that, as long as individuals continue to put their savings into 401Ks and broker accounts, they *comprise* the market. It's the dollars of the masses that drive the S&P; the stock market is a dictatorship of the proletariat (or at least the investing proletariat). Forget the Keynesians - we're all Bolsheviks of Capitalism now.

Though our actions might be influenced by analysts and closet corporate criminals, focusing on them is misguided. Most losses have nothing to do with fraud and everything to do with making investments we know nothing about based on advice we know to be inherently conflicted. As Judge Milton Pollack put it in his 2003 opinion:

> "**The alleged conflict of interest between brokerage firms, investment bankers and research analysts, was a matter of public knowledge for years before the amazing boom of the market initially rewarded those who disregarded such caveats**."

In other words, investors not only choose what they want to believe, but believe that what they’ve chosen is correct precisely *because* they have chosen it. Merrill didn't need the ‘intent to defraud’ because investors *want* to believe what they already have good reason to suspect is worthless blather. No stronger means of condoning a system than participating in it, right?

In Hannah Arendt's *The Origins of Totalitarianism*, the author observes that totalitarian rule relies on the assumption that *proving* that something is true is less effective than *acting* as if it is true. Fascists succeed because they are adroit in manipulating public participation; regardless of how absurd, once a belief is adopted, it *becomes* truth because the masses act on it.

The stock market is no different. If enough people believe that Amazon is worth $350 per share, for whatever reason, it will be worth $350 per share. Ask the shorts (once they finish washing their shorts). Anyone remember Infospace hitting $1,305 in March 2000?

Prices are established by a consensus of beliefs, and when the “common wisdom” craters, it does so because the belief has shifted. The participants cause their losses as well as their profits. Beliefs converge and create a trend, the trend feeds on itself and continues until the heretics (or paranoid) outweigh the faithful. The fractional fraud that occurs along the perimeter is irrelevant - until investors begin to suspect it is becoming pervasive. But there are probably too many incentives for fraud to become epidemic in the US. The prosecutors were never going to leave Martha Stewart to her kitchen once they sensed that her culinary fowl play had expanded to include financial foul play. Jack Grubman, the former Salomon Brothers analyst now banned for life from the securities industry, once barked "Why won't you people leave me alone!" at a pack of reporters because the system *doesn't* once it smells blood. Too many careers are built on destroying others’ careers.

It may seem I'm asserting that the stock market is a casino, but that's not quite it. You can't walk into a casino with a group of your friends and *decide* what number will win at the roulette table. But enough people decided Amazon was worth north of $350 that it actually went there. Of course, it came back down. Investors made that happen, as well.

The opportunity rests in distinguishing the objective from the aspirational and exploiting the chasm that separates them.

As Benjamin Graham one said, the stock market is a voting machine in the short run but a weighing machine in the long run. The market does have an objective set of referents, despite the inclination of most investors to ignore them. The factual basis of cash flows and balance sheets can't be evaded forever. If there's one thing that investors can count on, it's that all beliefs will eventually be forced to reckon with reality.

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