



1929: Can It Happen Again?

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Life for today's investors has become more complicated and increasingly frustrating. The reasons aren't complex. They're pretty straightforward. Investors need to make sound decisions. The lifeblood of all decisions is information. Three problems with fundamental information plague today's investors as they try to make sound decisions. (1) Today's 24/7 news reporting crams information into the investors' brains faster than they can digest it. (2) Today's news coverage concentrates relentlessly on mayhem, tragedy, and all types of negative sensational events. In most cases, investors are left with more form than substance. (3) Investors have real and understandable concerns about the credibility and accuracy of the information they receive, both from news organizations and public corporations.

The advents of cable and Internet news have added to the competition for audience (readers, listeners, or viewers) attention. The result is increased intensity for competition on the part of the media. This increased competition for audience attention has encouraged the media to focus on even more sensational stories. One of their favorite themes is comparing our current situation with the worst of times. Is this 1929? Are we about to end like the Roman Empire? Is this the beginning of the next world war? And so on. This type of news coverage leaves us wondering if we are close to some apocalyptic ending. Unfortunately, the media believes reality checks (even-handed presentations) don't attract audiences, so we get only one side of the story. All this adds to the investors' emotional concerns and frustration.

Certainly bad things are happening in the world. But good things are also happening, and so are new things. The best way to get a clear perspective on what is happening and where we're going is to remove emotion from the equation and list both the bad and the good elements. Then take those lists, put them in a balance sheet format, and compare the asset side of the balance sheet to the liability side.

The three areas investors are most concerned about are the stock market, the real estate market (both commercial and residential) and the state of the economy (i.e., recession, depression, employment, inflation etc.). The media inflame each of these areas by frequent comparisons with 1929. They promote the possibility that today's gross domestic product, unemployment rate, and banking system are becoming comparable to conditions in 1929.

Is it reasonable to think that today's stock market, unemployment rate, and banking system will end in a crash like the one in 1929? Is another depression similar to the one in the 1930s likely? Given the severity of the stock market decline, the unemployment rate, and bank failures, a comparison with the 1929 era is both inevitable and warranted. Following are the differences that affected the stock market, the real estate market and the economy between 1929 and 2002.

The Stock Market

The all-time high for the Dow Jones Industrial Average was 11,723. It occurred on January 11, 2000. Today (October 23, 2002) it stands at 8,400. That's a drop of 28%. During the market crash of 1929, the Dow Jones Industrials hit a high of 386 during September 1929, a level it didn't see again until November 1954 (25 years later). At its worst level, the Dow dropped to 40.56 in July 1932. That's a drop of 89% from the high.

NASDAQ didn't exist in 1929. NASDAQ's high was 5048.62 on March 10, 2000. Today (October 23, 2002) it's 1,300. That's a drop of 74%.

I won't regurgitate the NASDAQ story. It's been told often enough. Suffice to say that future values were promoted when present values didn't exist. Simply stated, when all you have is form over substance, you have a very vulnerable commodity. From its high on March 10, 2000, the NASDAQ has declined 74%. That's a percentage loss similar to the decline in 1929. NASDAQ has paid its price.

There is one obvious similarity between the stock market of 1929 and the stock market of 2002: Both declined. Apart from that, there's a world of difference between the conditions in the two time periods.

During the 1920s, the Dow Jones Industrial Average climbed from 100 to 386 and price earning ratios climbed from ten to twenty times. Many people, including President Hoover, thought this indicated that stock prices were too high in relation to their earnings. Today's media have attempted to compare the price earnings ratio of the 1920s (more than eighty years ago) with today's. In 1930, the population of the United States was 123 million, and 4 million people owned stock. That's one out of every 33 people. In 1998, the population of the United States was 270 million, and 84 million people owned stock. That's one out every 3.2 people. In other words, we have a different supply/demand relationship now than we did then.

One of the factors that helped to fuel an increase in stock prices was increased expectation. From 1925 on, American industry was overproducing. In anticipation (higher expectations) of eventually selling its surpluses, business leaders funneled their profits right back into industry, factories, machinery, and increased employment—all of which led to even more overproduction. This overproduction became overcapacity, and this overcapacity resulted in a precipitous fall when the next decline came.

Overproduction in industry is analogous to overbuilding in real estate. Overbuilding without occupants is described as speculative development. The more excess capacity created (by industry or real estate), the more speculative the environment becomes. The more speculative the economy becomes, the bigger the drop when the decline comes.

Today's computers have brought inventory control to a real-time basis. When a pair of dungarees is sold by Levi Strauss, its size, style, color, etc. are entered into a computer. The sale is analyzed, and if so determined, the item is replaced. The inventory and overproduction problems of the 1920s do not exist in 2002.

Investors' expectations, which were created by overproduction and high stock prices, resulted in a promotional environment (an unregulated market) replete with unsubstantiated rumors. Consequently, there were financial shenanigans in 1929, and there were financial shenanigans in 2002. In 1929 there was no financial watchdog with enforcement powers. There were no effective guidelines for buying and selling stock. Without any legal constraints, corporations began printing more and more common stock. Issuing more stock diluted the value of the stock and added to the supply in the market. There was no insider reporting. All of these factors expanded the existing promotional environment.

The Securities and Exchange Commission (SEC) was created in 1934. In 2002 the SEC sets and enforces laws, rules and standards for publicly traded companies. The SEC is authorized to investigate and prosecute where applicable. The existence of the SEC doesn't mean that fraud has been eliminated. It does mean that fraud can be made the exception rather than the rule.

The enthusiasm created by investors' expectations and rumors started by promoters motivated stock buyers to buy as much stock as possible. During 1929, stocks could be bought on 10% margin, which meant that a 10% decline caused a 100% loss of equity. A decline of more than 10% meant that the investor owed the brokerage firm money. The large stock losses of 1929 plus the inability of investors to add money to their account caused many brokerage firms to fail. In 1934, the Securities Exchange Act authorized the Federal Reserve to regulate margin requirements. Today the Federal Reserve requires a 50% margin plus a minimum of \$2,000 in the account.

The New York Stock Exchange added its own requirements for margin accounts. Stocks that sell for \$3 or less cannot be used as collateral for a margin account. A margin account's equity must be maintained at 25% of market value. Stocks designated as volatile will have stricter requirements.

The banking system helped to add to the increasing demand for stock. During the 1920s, banks bought stocks as well as giving individuals low interest loans to buy stock. Buying stock was further promoted because banks opened at the rate of 4 to 5 per day. This expansion was accomplished with few federal restrictions to determine how much startup capital was needed or what reserves to set aside against lending.

Once the stock market started to decline, the banks created additional pressure to sell by selling their own stocks positions as well as the stocks of their borrowers. During the market crash of 1929, 4,000 banks (almost 40% of the total) failed. Depositors watched their life savings disappear and could do nothing about it.

During 1933, Congress passed the Glass-Steagall Act. This Act banned any connection between commercial banks and investment banking. The purpose was to prevent market speculation from causing future bank failure. Recently, some elements of Glass-Steagall have been eliminated, and some observers believe it is time to repeal the act altogether.

To encourage people to start saving again and to build confidence in the American banking system, Congress passed The Banking Act of 1933. This act set more stringent capital requirements and created the Federal Deposit Insurance Corporation (FDIC). The FDIC became effective on January 1, 1934, and it provided depositors with \$2,500 coverage. Today, depositors have \$100,000 coverage.

The highly charged speculative investment climate that existed in the 1920s produced a short-term investment mentality. Investors held stocks for short periods, buying and selling frequently. Investors counted on their savings accounts for their future needs. During 1929, there were approximately 4 million investors in the stock market. Their knowledge of investing and financial planning was practically nonexistent. This combination added to the inflamed and emotional buying activity taking place in the 1920s.

Today, there's a considerable difference. As of year-end 2001, \$6.97 trillion was invested in mutual funds, which means that approximately 50% of all stock investments are being professionally managed. The funds are less subject to short-term investing, emotional reactions and poor financial planning.

The catalyst for this change was a proliferation of retirement programs that were made available to an increased number of people. Although incorporated businesses have long been able to set up retirement plans for their employees, unincorporated businesses were not able to do so until 1962. The Self Employed Individual Retirement Act created the Keogh Plan. This plan became effective on January 1, 1963, and it permitted sole proprietors and partners to participate in plans of unincorporated employers. Annual contributions were limited to \$2,500 and only 50% of the contributions were deductible. That amount has grown since then, and starting in 2003 the amount will be \$40,000 and it will be fully deductible.

From the beginning, the Keogh Plan has seen a proliferation of retirement programs designed to accommodate the different circumstances of individuals. Profit Sharing (formerly Keogh), Individual Retirement Account (IRA) (affects pretax dollars), Roth IRA (affects post-tax dollars), SEP IRA (for self-employed persons), 401K (Company Plans), Simple IRAs (401K for small companies), insurance annuities, nonqualified compensation plans (for executives), and defined benefits plans (pension plans) are examples of the many retirement programs available.

Because of these retirement programs, investors now have a long-term investment outlook, a desire for professional management, and a serious interest in understanding the financial ramifications of investing.

The Federal Reserve Board was criticized after the crash of 1929. The new President of the Federal Reserve Board, Adolph Miller reduced interest rates (from 6% to 4%) between October 1929 and February 1930. After that, monetary policy became ambiguous. Beginning in 1929, the interest rate charged on broker loans began to rise. This increase had the affect of reducing broker loans that originated from banks and lowered the liquidity of non-financial and other corporations that financed brokers and dealers. Government purchases in the open market declined. This reduced liquidity by lowering non-borrowed reserves. Then the interest rate was raised in 1931. Between the period of 1929 and 1933, the money supply dropped by 31 %.

The Federal Reserve Board is still an independent body whose interrelated responsibilities are the management of our money and the economy. The difference between then and now is its increased oversight and reporting responsibilities to Congress. Does this eliminate poor judgment? No it doesn't. What it does do is increase communication, and with increased communication there is less chance of exercising poor judgment.

Real Estate

The Savings and Loan Industry used to be the primary mortgage lender for real estate purchases. Prior to 1932, there was no steady, reliable source of funds for the Savings and Loan Industry. Consequently, most real estate financing was interest only (no amortization) with relatively short-term (five-year) balloon payments. When the stock market declined and unemployment increased, large numbers of balloon payments were not met and people defaulted on mortgages. These defaults added to the already serious banking and stock market problems.

In July 1932, the Federal Home Loan Bank Act was created. Its main purpose was to provide S&Ls with a steady reliable source of funds. In 1934, as a part of the Housing Act, the Federal Housing Administration (FHA) was created. Its purpose was to offer and guarantee affordable mortgages. Then, in 1938, The Federal National Mortgage Association (FNMA) was created. Its purpose was to introduce the secondary mortgage market. This secondary market provided lenders (on a broad geographical basis) with a

vehicle to sell their mortgage portfolios, thereby strengthening their balance sheets and their liquidity.

The federal government's program was brilliant. It offered attractive guaranteed mortgages and a secondary mortgage market. The result was the introduction of long-term amortizing mortgages. This type of financing set the stage for the expansion of homeownership in America without the catastrophic mortgage defaults of the 1920s and 30s.

Economy

There are lots of stories that describe the great depression of the 1930s. With almost 40% of the banks closing their doors, many people lost their life savings. There were no safety nets. Unemployment rates increased from 3.2% in 1929 to 24.9% in 1933. The gross domestic product declined from \$ 822.2 billion in 1929 to \$603.3 billion in 1933. That's approximately a 27% decline. By comparison, after World War II, the gross domestic product dropped 12%. Since War World II the gross domestic product has declined seven times, but no decline has been for more than 2%.

In 1933, America had a new president, Franklin Delano Roosevelt. He understood the importance of protecting the American economy. In 1938, he said, "The people of America are in agreement in defending their liberties at any cost, and the first line of the defense lies in the protection of economic security."

Roosevelt translated those beliefs into action. More legislation (The New Deal) was passed during his first 100 days in office than was ever passed before or since in the same time period. This new legislation was directed toward shoring up the banking system, offering long-term mortgage money for housing, providing safety nets for the unemployed and elderly, and providing work for the American public.

Some examples are as follows: The National Recovery Administration (NRA) was established in 1933 with the National Industrial Recovery Act (NIRA). This act attempted to end cutthroat competition by setting codes of fair competitive practice to generate more jobs and thus more consumer spending. In 1933, Congress passed the Agricultural Adjustment Act (AAA) to provide economic relief to farmers. The Works Progress Administration (WPA) was created in 1936. Under the WPA, buildings, roads, airports, and schools were constructed. Actors, painters, musicians and writers were employed through the Federal Theater Project, the Federal Art Project and the Federal Writers Project. In addition, the National Youth Administration gave part-time employment to students, established training programs and provided aid to unemployed youth.

But the New Deal's cornerstone, according to Roosevelt, was the Social Security Act of 1935. The federal-state unemployment compensation (UC) program, created by the Social Security Act of 1935, offered the first economic line of defense against the ripple

effects of unemployment. The Social Security Act of 1935 created a system of insurance for the aged, unemployed, and disabled based on employer and employee contributions.

Conclusions

Given these differences, there are some obvious conclusions: (1) There will not be another 1929 (at least in the foreseeable future). (2) The stock market is not going away. (3) Any further decline in the Dow Jones Average will be fractional when compared to the decline in 1929. (4) The recovery of the Dow Jones Averages to its prior high (11,723) will happen over a shorter period of time than the recovery after 1929 (25 years). (5) Speculative inventory buildup similar to that of 1929 is unlikely. (6) A decline in the gross domestic product comparable to that of 1929 is highly unlikely. (7) An unemployment rate comparable to that of 1929 isn't going to happen. (8) The banking system will not see similar problems caused by stock market investing, lending or short-term non-amortizing mortgages.

What strategies should an investor consider during these times? What we don't know is how long the current economic cycle will last. Terms like strong balance sheet, reasonable leverage, acceptable, usable product(s), current earnings and current yield should represent the majority allocation of every investor's portfolio. Consequently, staying power and current yield become very important for future investment success. You've got to be there when the economy turns, and you should be paid while you wait.