

A Day of Rest

Doug Wakefield with Ben Hill

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“By the seventh day God completed His work which He had done, and He rested on the seventh day from all His work which He had done.” Genesis 2:2

As we head into the third weekend of the month, it looks as though our illustrious financial leaders will once again find no rest this weekend. After working through the weekend of September 5th, to structure the US government takeover of the two *largest* holders of mortgages in the world (Fannie & Freddie), they continued over the weekend of September 12th, deciding that the 158 year old company that is the *largest* underwriter in municipal bonds (Lehman Brothers) would be allowed to go bankrupt and that one of the world’s leading wealth management firms (Merrill Lynch) would be bought out by one of the *largest* banks in the world (Bank of America), one would have thought that they could have taken some time off. Yet, no rest was found for the weary.

On Tuesday, the US government stated that in order to “stabilize” the markets, they would provide an \$85 billion loan to the *largest* insurance company in the world (AIG), the “collateral” being an 80 percent stake in the company. With the SEC (US) and the FSA (UK) temporarily suspending short sales of financial companies, it looks like the boys at the Treasury and Fed demanded that they do their patriotic duty to remove the thorns and thistles that had grown up to curse the “innocent” financial companies, who, I’m sure, gave investors no practical reason to want to sell their stocks.

So, with all the government interference surrounding the close of another options expiration week (see [The Day Free Markets Died](#)), we see the litany of political leaders, standing proudly in support of the US Treasury’s actions, as always, ready to drive our nation “[hundreds of billions](#)” of dollars further into debt, via the Federal Reserve’s electronic printing presses, while the SEC has acted to stop those nasty companies, like Profunds and Rydex, that dare to sell inverse funds that could help stabilize retail investors’ portfolios, in case the government’s massive (socialist) bailouts prove unable to remove all of the thorns and thistles from our markets.

As the financial ground on which we all stand grows more unstable by the week, our leaders sacrifice our children's futures to keep the almighty Dow from falling below the sacred 11,000 mark. The future of the dollar is being sacrificed so the Dow can achieve "price stability." As we contemplate the sustainability of these actions, consider the following from our March 28th, 2008 Short Report, On Commodities, Debt, & Government Intervention: The early 1900s & Today.

"To try and hold up wheat prices by keeping some of the supply of wheat off the market, on October 26th of 1929, the newly founded government-lending machine, the Federal Farm Board (FFB), announced it would lend \$150 million for wheat crops at up to 100 percent of the market price. As prices continued to fall in 1929, the FFB created another government agency – the Farmer's National Grain Committee (FNGC), which aimed to centralize all farmers' grain cooperatives and eliminate competition among them. While this was supposed to stabilize wheat prices, it only made matters worse.

By the middle of 1931, the Grain Stabilization Corporation, which replaced the 1929-formed FNGC, was authorized to purchase as much wheat as possible. Even after increasing their purchases by an additional 200 million bushels, prices continued to plummet. The larger FFB eventually threw in the towel and dumped their wheat stocks, resulting in a final collapse."

When I read the history of [America's Great Depression](#), I'm amazed at the lack of knowledge surrounding the events of 1929 to 1932. And, as the Dow moves up, investors are once again lulled to sleep, firmly committed to theories that have existed for less than 50 years, which, if used from 1929 to 1939, would have destroyed them. All they hear is that the state will always be there, and that debt, in the billions or trillions, will always provide a permanently stable solution. And now that the short selling serpent has been squeezed, the rivers of Eden will soon run smoothly again.

Consider these comforting words from SEC Chairman Cox:

"[The Commission](#) is committed to using every weapon in its arsenal to combat market manipulation that threatens investors and capital markets.

The emergency order temporarily banning short selling of financial stocks will restore order to the financial markets.”

Contrast his remarks, with those from US Treasury Secretary Hank Paulson this [morning](#):

“Last night, (Thursday, September 18th) Federal Reserve Chairman Ben Bernanke, SEC Chairman Chris Cox, and I had a lengthy and productive working session with Congressional leaders. We began a substantive discussion on the need for a comprehensive approach (see our March 2008, [Blueprint for a Modernized Financial Regulatory Structure](#)) to relieving the stresses on our financial institutions and markets.

We have acted on a case-by-case basis in recent weeks, addressing problems at Fannie Mae and Freddie Mac, working with market participants to prepare for the failure of Lehman Brothers, and lending to AIG so it can sell some of its assets in an orderly manner. And this morning we've taken a number of powerful tactical steps to increase confidence in the system, including the establishment of a temporary guaranty program for the [U.S. money market mutual fund industry](#).

Despite these steps, more is needed. We must now take further, decisive action to fundamentally and comprehensively address the root cause of our financial system's stresses.”

And what may we ask, is the root cause Mr. Paulson? Let me suggest one: a lack of ethics, which ultimately destroys confidence. Consider House Representative and Chairman of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises [Richard H. Baker's comments](#) from June 14th, 2001 as he speaks of the need to rebuild confidence in the integrity of our markets:

“There was a question on a recent magazine cover that struck me as particularly appropriate: “Can We Ever Trust Wall Street Again?”

To the extent that American consumers have been temporarily shaken by the recent market downturn, our first goal today here is to begin a process

of rebuilding that confidence, not only to reaffirm American consumers' faith in the fairness of the market, but actually to have their trust.

I am deeply troubled by the evidence of the apparent erosion by Wall Street of the bedrock of ethical conduct. Today, we are going to inquire into disturbing media and academic reports about the pervasive conflicts of interest, which appear to be compromising the integrity of current market practice.

Today, we focus on analysts' conflicts. At some point, we will take a look at the investment banks and the institutional investors."

Or consider the Congressional testimony of David Tice, President and founder of the sell side research firm, Behind the Numbers, and founder of the [Prudent Bear](#) funds.

"When credit is made readily available to the speculating community, failure to rein in the developing speculation risks ponzi-type investment schemes. Such an environment creates dangerous instability, what we refer to as financial and economic fragility. Sophisticated Wall Street, with its reckless use of leverage, proliferation of derivatives, and sophisticated instruments, is funding loans that should not be made. While such extraordinary availability of credit certainly does foster an economic boom, it must be recognized that history provides numerous examples of the precariousness of booms built on aggressive credit growth that are unsustainable and dangerous.

Tremendous political courage will be needed to effect changes in this area. Those who benefited from the current broken system have enormous financial resource. There is no question, Mr. Chairman, that Wall Street's research is riddled with structural conflicts of interest. This is an outrage. This conspicuous lack of objectivity in research is indicative of what we see as a general lack of responsibility on Wall Street today, one that's having a corrosive effect on the marketplace. What's at stake we believe is a sound and fair marketplace, which is at the very foundation of capitalism"

Or consider James Chanos', President and founder of Kynikos Associates, testimony before the US House of Representatives Committee on Energy and Commerce concerning Enron on February 6th, 2002.

“First and foremost, no one should depend on Wall Street to identify and extricate investors from disastrous financial situations. There are too many conflicts of interest, all of them usually disclosed, but pervasive and important nevertheless. In addition, outside auditors are archeologists, not detectives. I can't think of one major financial fraud in the United States in the last ten years that was uncovered by a major brokerage house analyst or an outside accounting firm. Almost every such fraud ultimately was unmasked by short sellers and/or financial journalists.

I want to remind you that, despite two hundred years of 'bad press' on Wall Street, it was those 'unAmerican, unpatriotic' short sellers that did so much to uncover the disaster at Enron and at other infamous financial disasters during the past decade (Sunbeam, Boston Chicken, etc.)”

Or, consider Chanos' statement at the US Securities and Exchange Commission [Roundtable on Hedge Funds](#), on May 15th, 2003.

“The public benefit of the 'long side' of the market is well understood by almost everyone in 21st century America; companies raise capital to fund investment, research and job creation; retail and institutional investors seek out equity investments in order to share in the creation of wealth that flows from well-managed, honest companies.

The public benefit from the 'short' side of the market is less well understood, but no less valuable. As Edward Chancellor, the noted expert in the history of finance, wrote in 2001, 'we need more, not less, shorting activity if, in the future, we are to avoid wasteful bubbles, such as the recent technology, media, and telecoms boom.

The short sellers provide the kind of independent research that is the marketplace's best antidote to the myriad conflicts of interest so amply revealed in the global settlement with ten leading Wall Street investment banking firms. Short sellers ask the tough questions and dig out the

discrepancies in the financial statements and other regulatory filings made by publicly traded companies.”

At this stage in the article, you may be saying, “But what about the naked short selling? Doesn’t that go on, and if so, shouldn’t this be stopped.” I first looked at the Federal Register of the United States Government and the National Coalition Against Naked Shorting to answer such questions for our own research paper on the topic of short selling. Once again, the following excerpt from a September 30th, 2006 [letter from NCANS to Nancy Morris, Secretary of the SEC](#) proves helpful.

“To be clear, NCANS is not against short selling, as we believe that short selling can be a beneficial investment strategy, and can enhance investor returns. Neither is NCANS against short-term delivery failures resulting from lost certificates, or mundane or reasonable occurrences. NCANS *is* against the practice of offering a product for sale, taking an investors’ money, and refusing to deliver the product sold in anything approaching a prompt manner – i.e., failure to deliver as a trading strategy.

It is against this manipulative and predatory practice that NCANS has marshaled its efforts, and it is this destructive practice that we believe the SEC should eliminate from our market system.”

In our research paper, [Riders on the Storm: Short Selling in Contrary Winds](#), at the conclusion of the section on naked short selling, we make it clear that the heated and distorted rhetoric that is coming out *today* keeps the public from understanding the root problem. If only bankers are protected, after proving to be reckless stewards of the financial capital given them, while thousands of companies’ stocks are not allowed such immunities, has the SEC really acted to restore fairness, trust, and confidence to the markets? If illegal activity is what our leaders wish to stop, then let them consider these words from our research paper, written in the fall of 2005:

“If illegal short selling is to be curtailed, it must be enforced. With the very real possibility of a substantial decline in the markets, this issue may move to the forefront in years to come. There are ethical and unethical participants on the long side of the markets. In the same way, we can see

that there are ethical and unethical participants on the short side of the markets. Since history has repeatedly shown that after periods of market declines short sellers are often scapegoated, should there come a period of great demagoguery against short sellers, our desire, for the record, is to make it apparent that there are differences between ethical and unethical short sellers." [Page 122, Riders on the Storm, January 2006]

As more and more investors wake up the fact that markets are not random and that government leaders will always claim the moral high ground, in their efforts to rescue the system by destroying the dollar and driving us hundreds of billions of dollars further into debt, then whether you use short selling tools, search for the safest place to hold your cash, hire a professional long-short or short-only manager, or move a portion of you money to gold bullion, you are conveying your distrust of the government proffered solutions, preparing for the day when the dam will no longer hold. Science shows us that equilibrium will be achieved at some point, no matter how much some believe that the tower can always be built (ever) higher.

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A current subscription to our research gains an individual access to all of our educational writings back to January 2006 as well as our industry research paper on short selling, Riders on the Storm: Short Selling in Contrary Winds.

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