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INSTITUTIONAL ADVISORS

OCTOBER 8, 2003

**BOB HOYE**

# INDEPENDENT RESEARCH

and the

## FOUNDATIONS OF MODERN FINANCE

For some, modern finance started when they walked into their first lecture in Economics 101. For others, it was the inception of the Federal Reserve System with the concept of a "flexible" currency way back in 1914.

For those around then, it was thought to be new and modern and, with the contagion of the 1929 boom, John Moody (yes, of Moody's) claimed it was vastly superior to the widely discredited previous agency, the Treasury System. His scornful view, which was conventional wisdom of the day, should be compared very carefully with the regard for the old system when it was excitingly modern.

But before getting into exquisite ironies, it's worth noting that there have been six New Financial Eras since the first one blew out in 1720. Each has been identical in duration, compulsive participation, and dramatic climax. In all previous examples, senior bankers, journalists, and even satirists were capable of identifying the action, in real time, as a financial bubble. Even the first one was properly labeled, but in a remarkable lapse of perspective our leading financial types were unable to make the distinction in 1999 and 2000.

The explanation of this failure is too serious for any luncheon, particularly today's. So we will follow the thread of modern finance back in time, specifically to the unbridled regard for the old Treasury System during the financial bubble that climaxed in September, 1873. As with examples before or since, the exhaustion of a speculative frenzy is anticipated by increasing financial stress, indicated by soaring interest rates within an inverting yield curve and widening credit spreads.

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This was the case in late summer 1873 and the leading NY newspaper editorialized that the Treasury-Secretary had powers greater than those of a mere central banker and therefore nothing could go wrong. The irony is that the initial phase of the contraction lasted for six years and in England, which was the preeminent economy, the period from 1873 to 1895, was eventually described as "The Great Depression". That's by senior economists and they seriously discussed remedies and preventatives until as late as 1939. That's when another and more pressing "Great Depression" was suddenly discovered. It's true.

In order to avoid a lot of details, it's best to go to a summary about what's really modern in finance – actually, not much. Since at least Roman times, there are examples of buying panics and agencies with the urge to over-issue credit finding each other and creating a bubble. And such over-excitement has always been followed by severe credit contractions.

Furthermore, policymaking tools have always been the same. Currency depreciation, protectionism to change trade flows, forced loans, programs for the poor, and artificially lowered interest rates for farmers. A delightful book, **"The New Deal in Old Rome"**, relates how policymakers then fought contraction with acronyms. Of course, President Roosevelt ended the 1930s' Depression with a wonderful set ranging from NIRA (National Industrial Recovery Act) to the TVA (Tennessee Valley Authority) and the emperors attacked contractions with acronyms ranging from HOLC (Home Owners Loan Corporation) to FCA (a farm credit administration). Actually, Rome's bureaucrats attacked the business community with depreciation and confiscatory taxation until the empire collapsed.

While policymakers' habits have changed little over the past 2000 years, a new tool did arrive in 1694 with the inception of the Bank of England, which eventually provided a widely circulating set of notes from a single bank. After some defaults, the modern convertible bank note provided its efficiencies to both domestic and international trade.

Although a new tool of government and trade, the central bank was only one aspect of the development of modern finance. Essentially, this was the evolution of a means to exchange equity and debt and, by this, we are talking about the liquidity that only a public market provides.

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Time bargains in the form of options and forward settlements in interest rates or foreign exchange transactions date back to the 13<sup>th</sup> Century, which was a mark of modernity. When necessary, some of these transactions were designed to bypass the compulsion of those in government who didn't understand the markets and felt compelled to impose arbitrary notions about artificially lowering interest rates or preventing them from rising through usury laws.

However, it is reasonable to note that a really modern financial world started voluntarily in the mid-1600s when there were enough publicly traded stocks with enough participants to label the action as a stock market or, to use the latest in portfolio theory, a market of stocks.

Either way, it was private initiative at its best and, as history recorded, soon at its extreme. The first big boom set the model for all others since. The speculative mania funded innovation in business, the action became compulsive, and collapsed. Impatience and chagrin followed.

The first mania was in turnpike roads and the improvements in productivity were fabulous and soon known to all. Then there was a delay until the benefits were realized and the impatient reflected upon the former good times with the boom. A wit celebrated the phenomenon with a poem:

*Now with Turnpikes are grown  
much in fashion  
the hardest Tax in all our Nation  
- for when Wine & Women  
& Stock-Jobbing past;  
the Turnpike must help us at last*

This reminds of the crash in the energy play in the mid-1980s. At congressional hearings, outraged politicians were working over the CEO of a busted Oklahoma bank. When asked where the depositors' money had gone, he said, "*Oh, we spent it on wine, women, and song – the rest we just pissed away.*".

This classic pattern of brokerage, underwriting, and crowd behaviour has replicated many times since. Although violent at times, it must ultimately be seen as constructive for there is no better way of raising and productively employing capital than through freely trading markets.

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With the development of publicly traded stock and bond markets, the next step towards a fully modern market was the advent of research, independent of the function of creating and distributing securities.

The term broker or, as it was written and likely pronounced in the early days, "brogger", dates back to the 1500s.

Underwriting is another function of finance and it was originally described as undertaking. A remarkable example of this and government gullibility occurred with the prototype of the modern new financial era.

That "new era" started with the end of the "old era" of inflation in 1609 (think 1920). The immediate hard recession and subsequent weak pricing abilities created widespread unemployment, particularly in the cloth trade. At the time, England shipped basic cloths to the Netherlands, which was the financial and commercial centre of the world. Those who didn't know better became envious of the "value added" obtained by finishing the cloth in Flanders and promoted a scheme to capture this by finishing the cloth in England. Today, this would be the equivalent of taking Western Canada's raw materials and setting up production to sell cars to Japan. In a post-inflation stagnation, it was impossible to support existing, let alone additional, capacity.

Within a sluggish economy, a projector persuaded the British Crown to finance the duplication in England of cloth-finishing capacity. As business conditions began to deteriorate in 1618 (think 1929), the King became apprehensive – particularly as successful merchants described the scheme as "*a Sepulcher – attractive without, Dead bones within*".

Then in November of that fateful year, which was seasonally appropriate for financial calamity, the Archbishop recorded that the King told the projector, "*in could bloud before ye Council Table yet if he had abused him by wrong information his 4 quarters should pay for it*". As this meant "hanged, drawn and quartered", the Archbishop continued with "*ye poore Alderman stood infinitely amazed*".

As the scheme included supporting the domestic economy by buying unfinished cloths, it prompted other practical comment.

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A well known letter-writer by the name of Chamberlain observed that it was strange that *"the wisdom of the state could be induced to [rely upon] the vaine promises of ydle braines"*.

Other than this, little is known about Chamberlain but, as he is described as a writer rather than as a broker, undertaker, or merchant, it is tempting to consider him as an independent researcher.

Until efficient printing presses became available, overly ambitious governments believed the promises of alchemists and were their main funders. In the 1560s, the newsletter of one of the most powerful banks in history derided alchemists so perhaps Chamberlain's ridicule of other schemes by *" ydle braines"* was practical and not too isolated.

His comments would be applicable to the boasts of many interventionist economists of the past 100 years.

While it would be interesting to learn more about Chamberlain's role in financial history, John Houghton started what could be called the first market letter in 1692 and it is tempting to conclude that this was the start of independent research and it preceded central banking by two years. Identifying himself as independent of brokers, he intended to record the industrial progress of the time. Following a leading article or essay, each edition provided commercial intelligence as well as quotations on some senior stocks.

In the latter, some were listed by their nicknames, of which one is still traded. Despite 310 years, the "Bay" is still the term for the Hudson Bay Company. One called "Wreck" was involved in salvaging shipwrecks and "Blue" was not the predecessor of IBM but a manufacturer of coloured wallpaper.

Beyond convoluted phrasing, the other difficulty for today's reader is the font used in the 1690s. The small "s" looks very much like a small "f" so Houghton's advice to those who were totally averse to equities went as follows: *"My readers [should not be] pre-poffeffed against Trading in Stocks."*

Over the years, his essays included instruction on option strategies with, as they were called then, "puts" and "refusals". One was titled **"The Great Mystery of Buying More Than All"** and

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described a successful short squeeze, which elaboration is not needed for this audience.

Most, if not all, of the elements of modern finance were established by the late 1600s. Houghton's publication must have been worthwhile for it ran through very volatile conditions from 1692 to 1707. For example, from a high in 1692 of 260, the "Bay" plunged to 80 in 1697 and, on the same move, East India fell from 200 to 37.

This brings us to the two most abused concepts in the financial literature. One dates back to the 1570s, which is the notion that some agency or clique of key players can raise or lower interest rates at will. Depending upon the position of the viewer, these have occurred as either complaints or boasts. To this day, the history of interest rates has shown little regard for either pitch.

The other concept dates to the James I bust of 1618-1622 and it is typically uttered by some intellectual with inadequate market experience and too much personal outrage about the liquidity vacuum that follows every speculative binge. The subsequent hard times seem to prompt those with an enormous ego to provide a remedy. Essentially, these have been the same whether from Misselden in the 1620s' bust and contraction to Keynes in the 1930s' equivalent. There is no need to be concerned that Keynes plagiarized the same concepts promoted by his predecessors. Hayek observed that Keynes was "*totally ignorant*" about financial history.

Generally, these ideas come under the "fund of credit" notions that proponents claim as a cure for the fallout of too much credit being created "out of thin air" during a wild asset inflation.

On the other hand, not enough can be said about the contributions of earlier merchants, traders, and financiers in building today's prosperity. Were they bright? - Of course, can you imagine doing interest rate calculations in pounds, shillings, and pence, and in Roman Numerals – all without a yield book?

To be serious, the posterity of every successful entrepreneur is today's vast pool of capital, which created and ensures our remarkable standard of living. Over the centuries, successful entrepreneurs and investors have learned the impartial rules and disciplines of the marketplace, but only a few wrote down the market sense they all knew so well.

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The fantasies of the *'ydle braines'* of Misselden or Keynes have been placed in perspective by the common sense of Sir Thomas Gresham, as one of the great traders in history. As Elizabeth's financial agent in the world's financial capital, then in Antwerp, he recorded "streat" wisdom in letters to Her Majesty, which she wisely acted upon.

Although it is not known if John Houghton was wealthy, his posterity is a record of good advice and quite likely the innovator of independent research. There have been other successful students of the market, such as the 1920s' Jesse Livermore, whose ghost-written "**Memoirs of a Stock Market Operator**" is well worth reading. Also, we shouldn't overlook Daniel Drew's sage advice from the 1860s on short-selling. *"He that sells what isn't his'n must ultimately deliver or go to prison."*

Gerald Loeb's "**The Battle of Investment Survival**", published in 1934, made the classic quip about stock analysts *"In a bull market, who needs them and in a bear market who wants them?"*.

However, as fascinating as financial history is, it is time to close out this address.

Ladies and gentlemen, please stand with me and raise your glass *"to the absence of ydle braines and to John Houghton, the Father of Independent Research"*.

**BOB HOYE, INSTITUTIONAL ADVISORS**  
E-MAIL [bobhoye@institutionaladvisors.com](mailto:bobhoye@institutionaladvisors.com)  
WEBSITE: [www.institutionaladvisors.com](http://www.institutionaladvisors.com)