

EFFICIENT MARKETS (Part 2)

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Modern markets are impressive. In late 1999-early 2000, the surge in demand for speculative stocks was without precedent. Then, with a fabulous thrust of investment banking, Wall Street rose to the occasion and satisfied a demand that was thought to be insatiable. Capitalism at its finest. Of course, every issue was accompanied by an SEC-approved prospectus so there was no opportunity for deception – a perfect combination of free enterprise and regulatory sanction.

These skills were not isolated. In the first quarter of this year, the demand for high-yielding corporate bonds narrowed spreads so much that a shortage of junk-bonds seemed possible. Then, faster than investment bankers could possibly create new issues, there was a typical post-bubble rush to downgrade investment grade bonds to junk – supply met demand without underwriting fees.

Even the process of downgrading is becoming more efficient. As with previous manias to float essentially uneconomic debt issues, the discovery of the inability to service them is rapid. Rating agencies have, themselves, found this so fast that they have been able to compress three stages of announcements into a single but dreadful "triple-notch" downgrade.

Although it seems like dereliction of oversight, many countries' bond issues are done without regulatory approval, in which case, in the inevitable post-boom cluster of defaults sovereign issues can go from investment grade to junk without the burden of costly prospectuses.

A portion of modern portfolio theory is concerned about transaction costs. Although most, if not all, retail investors are innocent of such knowledge, some have found a way of minimizing expenses through complacency. There are reports of unsophisticates downweighting positions by some 80% without suffering commission costs. This, of course, will be finessed when even the number of shares is reduced by rollbacks. Little corporate financing fees on this one.

Efficient markets rule!

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