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# Investors had little choice but to keep on dancing

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Most post-mortems of the financial crisis have diagnosed one of two causes of near-death: greed or stupidity. The greed school focuses on the excess of the world's financiers and the spendthrift ways of American consumers and home-buyers. The stupidity camp zeroes in on the mistakes of individuals and institutions: the CEOs who did not understand their own off-balance sheet assets; the ratings agencies who believed sub-prime mortgages could be packaged into triple A securities; the regulators who missed **Bernard Madoff's fraud**.

Both arguments are right. But individual ignorance and avarice are just sideshows; the biggest driver of the crisis was systemic. The boom – and bust – happened because investors obeyed the logic of financial markets.

That logic was what Chuck Prince had in mind when he made his notorious remark to the FT in July 2007. "When the music stops, in terms of liquidity, things will be complicated," Mr Prince said, when asked about problems in the US sub-prime market and growing difficulties financing private equity deals. "But as long as the music is playing, you've got to get up and dance. We're still dancing."

The vivid phrase helped scupper his captaincy of Citigroup – but Mr Prince was right. It would be nice if financial markets consistently rewarded sober-minded investors and prudent CEOs who are unmoved by the animal spirits of the crowd. But markets demand conformism. As investor Barton Biggs pointed out, in a line that may have been subconscious inspiration for Mr Prince's quip: "Only fools are dancing, but the bigger fools are watching." Keynes, himself, had warned that the market can stay irrational longer than you can stay solvent.

In a seminal 1997 paper on behavioural finance, economists Andrei Shleifer and Robert Vishny argued that being "right" about market fundamentals is not enough. Arbitrageurs who bet on a mis-pricing of assets can be forced out of the market if their bet is premature – by the time their view is vindicated, they may no longer be in business.

In an empirical study of the 2000 tech bubble, economists Markus Brunnermeier and Stefan Nagel found that even as tech stocks were becoming more over-valued, hedge funds increased the share of their portfolios devoted to the sector. "Hedge funds did not exert a correcting force on stock prices during the technology bubble," they found. "Instead, they were heavily invested in technology stocks. This does not seem to be the result of unawareness of the bubble."

Even more perversely, the most famous Cassandra was punished for his prescience. "The manager with the least exposure to technology stocks – Tiger Management – did not survive until the bubble burst," Brunnermeier and Nagel point out.

The asset bubble, which burst in 2007-08, was likewise spotted in advance by many fund managers and CEOs. But shareholders and investors had little patience with those who bet against the bubble too soon: one reason Phil Purcell was ousted at Morgan Stanley was his unwillingness to take on as much risk as his rivals. Even John Paulson, whose bet against sub-prime was the biggest windfall of the crisis, had to endure white-knuckle losses before hitting the jackpot.

Last week, **Alan Greenspan**, the former Federal Reserve chairman, reiterated to the FT his now landmark admission that he was "shocked" that market participants had taken on too much risk, to their personal and institutional detriment. He also fell back on his more long-standing belief that the crisis was a "once in a century" event and that markets could be relied on to impose more cautious practices in the future.

Both views are wrong. It should not be a "shock" that market participants took on risk as the bubble grew: that is what the logic of financial markets required. Nor will today's chastened investors be prudent for long. As Brunnermeier and Nagel conclude: "Our findings question the efficient markets notion that rational

speculators always stabilise prices.”

The problem with requiring financial players to keep on dancing while the music plays is that only the very lucky and the very smart are quick enough to grab a chair when the music stops. That is why the wisest participants know it is in their interests – and those of the taxpayer – for a more powerful regulator to be established with the authority and courage to slow down the music for everyone.

*The writer is the FT’s US managing editor*

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