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The losses ensuing from the reaction of the securities market which is bound to occur sooner or later if prices have been driven "too high" by speculation, are what people usually refer to when they speak of "stock exchange losses," and are the target of their most vehement criticism. These losses, however, are exclusively shifts in the distribution of wealth and of income: they do not in themselves represent any loss to society. This point is not clear even to many trained economists and probably needs to be explained in greater detail.

Fritz Machlup
The Stock Market, Credit and Capital Formation (1940)

It's not wealth that's increased in the last few years. We haven't increased our productive capacity. All that's increased is the paper values of our stocks and real estate. But that's not real wealth … When you see the stock market come down and the real estate bubble burst all that phony wealth is going to evaporate and all that's going to be left is all the debt we've accumulated to foreigners.

Peter Schiff
Interview on CNBC (28 August 2006)

It would be irresponsible in the extreme for an individual to [attempt to] forestall a personal recession by taking out newer, bigger loans when the old loans can't be repaid. However, this is precisely what we are planning on a national level.

I believe these ideas hold sway largely because they promise happy, pain-free solutions. They are the economic equivalent of miracle weight-loss programs that require no dieting or exercise. The theories permit economists to claim mystic wisdom, governments to pretend that they have the power to dispel hardship with the whir of a printing press, and voters to believe that they can have recovery without sacrifice.

As a follower of the Austrian School of economics I believe that market forces apply equally to people and nations. The problems we face collectively are no different from those we face individually. Belt tightening is required by all, especially governments.

Governments cannot create but merely redirect. When the government spends, the money has to come from somewhere. If the government doesn't have a surplus, then it must come from taxes. If taxes don't go up, then it must come from increased borrowing. If lenders won't lend, then it must come from the printing press, which is where all these bailouts are headed. But each additional dollar printed diminishes the value of those already in circulation. Something cannot be effortlessly created from nothing.

Peter Schiff
"There's No Pain-Free Cure for Recession"
The Wall Street Journal (27 December 2008)

All Hail Recessions, Bear Markets, Bankruptcy and Failure

"The past twelve months have been humbling," the editor of an investment newsletter wrote in the closing days of 2008. "The figures which will appear in our annual Performance Report (which we'll rule off at 31 December) will almost certainly be frightful, unwinding several years of outperformance. Our analysts recently got together for our annual conference, and not surprisingly it turned into something of a two-day post-mortem. It was a sombre affair where we pored over our mistakes and discussed how we might be able to improve our investment process."

What, in their view, went awry? "The general diagnosis … was that the bull market built up a head of steam and we struggled to find value in the strong blue chip businesses we love, our attention turned to the few stocks that were out of favour. This took us off the beaten track, to smaller stocks where we felt a case for value could be made. The share prices presented fewer problems than the blue chips, but the underlying businesses were less robust. And, as the market and economy turned down, in many cases their managements proved less prudent and shareholder-friendly than we'd hoped."

Further, "while our fierce independence helped us avoid failing with the crowd (we steered clear of areas such as property trusts, most parts of the resources sector and many former high-flying stocks), in the end we failed unconventionally, with lousy recommendation on [mid- and small-cap] stocks … From a business perspective, failing unconventionally may actually be more painful than simply following the herd. American funds managers used to have a career-saving aphorism that 'you can't get sacked for buying IBM.'"

What is to be done? According to the editor, "We believe our independence is a strength, though sometimes extreme independence of mind has led us into dangerous waters – something we'll be aiming to correct in the future. The first steps we'll be taking involve a broader cross-checking of key recommendations throughout the team than the current three-level process (analyst, research director or managing director, then editor) and also by more regularly forming teams of analysts to examine stocks and sectors rather than simply assigning individuals. This rigorous approach will be more costly and labour intensive, but should result in more rounded research." A better process will produce better results, and a better process apparently requires less individualism and independence. Allegedly, it also demands more teamwork and consensus – and thus collectivism and groupthink (see Groupthink and You by Karen de Coster and Brad Edmonds).

Journalists, too, are looking to learn from the events of the past year. "In financial terms," Annette Sampson wrote recently ("Lessons in the Carnage," *The Age* 17 December), "2008 was truly an *annus horribilis* and the sooner we get shot of it the better. Share prices slashed in half, a falling Australian dollar, frozen investments, companies going bust, rising unemployment and talk of recession … Do I really

need to go on? We've all lost money [sic] and are hopefully wiser for the experience. But what are the lessons from the carnage?" (see also Six Lessons for Investors by John Bogle).

Most of Sampson's main points are sensible. As a rough rule, and other things equal, a company (and, for that matter, an individual) possessing a low and falling load of debt (or no debt) stands upon firmer financial ground than one burdened with high and rising debts. Cheap and plentiful credit encourages borrowers to become complacent – and thereby to shoulder much more risk than they realise. When the central bank's counterfeiting of credit and the exuberance of borrowers causes the prices of stocks, bonds and real estate to rise, the crowd exults that leverage is a fine thing; but once the boom inevitably causes the bust and prices fall, borrowers learn that leverage is ultimately lethal.

Another sensible rule is that a diversified portfolio of financial assets tends over the decades to generate better results than a concentrated one. In particular, and following the principles that Benjamin Graham outlined in *The Intelligent Investor*, a portfolio that comprises (say) 50% quality stocks and 50% investment-grade bonds will generate somewhat better results than an 80%-20% blend of stocks and bonds. Yes, during good times stocks will likely outpace bonds by a wide margin; but during funks they usually fall much further than bonds – and require much longer (sometimes a decade or more) to recoup their losses. Never forget that the tortoise eventually outpaces the hare. If your portfolio resembles the first (diversified) one, then over the past year you've probably slept more soundly than the fellow who once boasted about the "performance" of his stock-heavy portfolio (see also How to Invest Well and Sleep Better by Jonathan Burton).

The events of the past year have also demonstrated – Sampson hints at this vital point but doesn't state it explicitly – that governments have not extinguished the business cycle. Quite the contrary, they have exacerbated it. Until late 2007, and in both economic and financial terms, the mainstream insisted that the alleged stability (namely the absence of another Great Depression) of economy and finance since the Second World War constituted undeniable evidence of the triumph of the welfare state of credit. Mainstream economists[1] not only advanced

[1] "Mainstream economics," says Wikipedia, "is a loose term used to refer to the non-heterodox economics taught in prominent universities. Mainstream economists are not generally separated into schools, but two major contemporary orthodox economic schools of thought are the Saltwater school of the US coastal universities, notably including MIT, Berkeley, and Harvard, and the Freshwater school of the University of Chicago, which is associated with the Chicago school of economics. The Saltwater school is associated with Keynesian ideas of government intervention into the free market, while the Freshwater schools are sceptical [sic] of the benefits of the government."

Closely allied to the failure of mainstream economics is that of its cousin – mainstream finance. Perhaps most notably, and likely to generate schadenfreude, on 4 December 2008 *The War Street Journal* reported "Harvard University's endowment suffered investment losses of at least 22% in the first four months of the school's fiscal year, the latest evidence of the financial woes facing higher education.

this assertion confidently: they ignored or denigrated anybody who dared to doubt it. "Macroeconomics was born as a distinct field in the 1940s as a part of the intellectual response to the Great Depression," said Robert Lucas in his Presidential Address to the American Economics Association (2003). "The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades …"

Students of the Austrian School have long dared to doubt. This purported stability, they retorted, was not evidence of *success*: it was an indication of *artificiality*. For decades, Soviet Communism was also "stable." But its sudden and unexpected implosion in the early 1990s confirmed – just as Ludwig von Mises foresaw in Economic Calculation in the Socialist Commonwealth (1920) and in Socialism: An Economic and Sociological Analysis (1922) – that it had always been unworkable. Its collapse was inevitable; only the timing of its disintegration was uncertain. The good news is that exactly the same point applies to American (and, more broadly, Western) socialism and imperialism.

Since the middle of 2007, the mainstream has refused even to question (let alone reconsider) the interventionism and statism that forms its core. Indeed, during the past year most of its members have become even more stridently interventionist and statist. They have championed the Bailout of Abominations (whose official title is the Troubled Asset Relief Program and which for truth's sake should be dubbed No Money-Centre Bank Left Behind), the rescue of car manufacturers and a "new New Deal."[2] Reality has, however, forced the mainstream to prune

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"The Harvard endowment, the biggest of any university, stood at $36.9 billion as of June 30, meaning the loss amounts to about $8 billion. That's more than the entire endowments of all but six colleges, according to the latest official tally. Harvard said the actual loss could be even higher, once it factors in declines in hard-to-value assets such as real estate and private equity – investments that have become increasingly popular among colleges. The university is planning for a 30% decline for the fiscal year ending in June 2009."

2 On 7 January, *The War Street Journal* ("Reagan Aide Backs Obama on Stimulus" by Justin Lahart) reported "Martin Feldstein is an unlikely Democrats' darling. The onetime presidential adviser to Ronald Reagan might even be considered the least likely advocate of government spending to boost the U.S. economy. But given present circumstances, the Harvard University economist has changed his mind. Mr. Feldstein will be featured Wednesday at a Democratic economic forum, along with Robert Reich, former labor secretary and longtime liberal. Democratic leaders now mention Mr. Feldstein's support when they discuss their economic recovery plan. 'We're down to fiscal policy, which pains me a bit, more than a bit, but I don't think we have a choice,' said Mr. Feldstein."

During his final press conference (12 January), George W. Bush said "I readily concede I chunked aside some of my free market principles when I was told by chief economic advisers that the situation we were facing could be worse than the Great Depression. So I've told some of my friends who've said – you know, who have taken an ideological position on this issue, you know, 'Why'd you do what you did?' I said, 'Well, if you were

some of its smugness. According to Paul Krugman[3] ("Fighting Off Depression," *The New York Times*, 5 January 2009), "The recent economic numbers have been terrifying, not just in the United States but around the world. Manufacturing, in particular, is plunging everywhere. Banks aren't lending [sic]; businesses and consumers aren't spending [sic]. Let's not mince words: this looks an awful lot like the beginning of a second Great Depression."

Sampson's article contains a fourth set of important points. Political, economic and financial "leaders" possess soft heads and clay feet, and neither they (nor we) can foresee the future to any reliable degree of accuracy. Hence humility is vital. So too is scepticism. "Even the financial leaders of the world don't really understand everything that is happening, what the consequences are and how it will evolve … For years Alan Greenspan was 'the maestro of the market' and now he's to blame for everything that has gone wrong. Practically all the forecasts that the market mavens have made have been disastrously wrong. There have been forecasters who simply extrapolated the recent past and suggested it would continue and that has been a disastrous error of judgment." Hence investors worthy of the title should disregard short-term forecasts and predictions. "Don't make decisions based on variables that are impossible to predict or control over the short term. Instead, focus your energy towards creating a diversified portfolio, developing an appropriate time horizon and setting realistic return expectations."

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sitting there and heard that the depression could be greater than the Great Depression, I hope you would act too,' which I did."

Are all American Republicans such shameless and spineless "flip-floppers"? James Ostrowski writes in Bush the Pragmatist, "One of my constant themes in my blogging is the virus of philosophical pragmatism. To pragmatists, ideas do not reflect an objective reality but are merely tools to manipulate others. Bush never was a proponent of free markets in the sense that he believed that theory accurately described or reflected reality. Rather, it was some mumbo-jumbo that Rove whispered in his ear for the rank and file suckers to hear so he could get elected. Naturally, when a major crisis came, he didn't repair to his theory of reality as Grover Cleveland did; he never had one. Rather, he simply switched to a different word formula that seemed useful at the time to manipulate others and maintain power and control."

[3] Krugman was the 2008 recipient of The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel (commonly and misleadingly called the Nobel Prize in Economics). That's right, Virginia: there simply is no "Nobel Prize in Economics." Instead, there's a Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel. Since the beginning of the 20th century, the Nobel Foundation has endowed prizes in Chemistry, Medicine, Literature, Peace and Physics; since 1969, on the other hand, Sweden's central bank has awarded its prize in Economics. Given that central banks are bulwarks of statism, and ignite the booms that cause the busts, it's hardly a surprise that the Bank of Sweden typically awards its prize to people who worship the state and champion disastrous policies of government intervention. Friedrich Hayek, who was awarded the prize in 1974, is only a partial exception to this rule: much to his irritation, he was a co-winner with the unrepentant socialist Gunnar Myrdal. See also Filling the Holes in Krugman's Analysis by Robert Murphy.

Five Tough Economic Lessons from the Austrian School

According to at least one newsletter editor, then, the major lesson that emerges from the events of 2008 is that a process of investment that entails less individualism, independence and frugality, and more bureaucracy, consensus and expense, will beget better results. No, it won't. Why not? Because such a process forsakes Graham and Buffett.[4] According to Annette Sampson, the events of the past year remind us

1. to eschew debt and a stock-heavy portfolio;
2. that the business cycle never was extinguished, after all;
3. that "leaders" don't command all that they survey, and that they cannot foresee the future to any reliable degree of accuracy;
4. that humility and scepticism number among the investor's most essential traits of character.

These injunctions are fine, but they're also rather thin. Even less satisfactory is the exculpatory claim, advanced by many (including Alan Greenspan), to the effect that "this has been a once-in-a-century [sic] event; hence it's so far beyond anybody's experience that nobody could have foreseen it; so don't blame me." The head of equity research at an Australian financial institution provides an example:

> My experience over the past 30 years has all been in a period of normal business cycles. Investment markets overshoot on the upside and downside but we've experienced a benign trend for probably the past 50 years. This whole experience is more in the nature of something that is once in a longer period. People haven't experienced it before … It has absolutely taken everyone by surprise [sic]. I've spent a lifetime in the market and learnt that if

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[4] In Chap. 8 of *The Intelligent Australian Investor*, I observed "Graham-style value investors are staunch individualists. The disagreement of others does not dissuade them from a course of action. Nor do they undertake something simply because others are doing it. As Benjamin Graham emphasised, the intelligent and truly conservative investor derives satisfaction rather than worry from the thought that her operations are diametrically opposite those of the crowd. That is just as well. Since the 1970s, Grahamite value investors have stood ever further apart from the financial mainstream. Indeed, as the conventional wisdom has hardened into ever stricter and arcane orthodoxy, they have become more and more critical of the majority."

In Chap. 9 I added "As staunch individualists, Grahamite value investors are well positioned to resist what Irving Janis called 'Groupthink' and to withstand what Warren Buffett has dubbed 'the institutional imperative.' This is the tendency (which is particularly marked during booms and busts, is endemic within committees and small groups and is often present in a milder form throughout organisations) to imitate others' behaviour – no matter how absurd or destructive it might be. When they are members of teams, in other words, people do things that they would never countenance as individuals. To defy the institutional imperative is, when applied to the allocation of capital, to ignore the crowd and committee, embrace individual self-reliance and invest on the basis of reason and enduring value rather than emotion and current popularity."

> you're patient, hold for the long term and look at the fundamental valuations you should be rewarded. But so far it hasn't panned out the way it is supposed to … One hard lesson learnt is that buying into the dips is not always a guaranteed way to make money. In this market, the dips have often been followed by further falls … It's the nature of investing that we have to relearn the same lessons.

John Bogle cites the Roman orator Cato ("there must be a vast fund of stupidity in human nature, or else men would not be caught as they are, a thousand times over, by the same snares . . . while they yet remember their past misfortunes, they go on to court and encourage the causes to what they were owing, and which will again produce them") and concludes: "While the events of 2008 reinforced that message, perhaps these stern and oft-repeated lessons of experience will help investors avoid similar mistakes in 2009 and beyond."

I don't disagree, but I'm hardly satisfied. To borrow Peter Schiff's words, the mainstream's lessons "promise happy, pain-free solutions. They are the equivalent of miracle weight-loss programs that require no dieting or exercise." They encourage the market participant to say to himself, "Beware of debt, check; balance the portfolio, got it; so now I can expect to return to what almost twenty years of propaganda has conditioned me to regard as 'normal' results, right?" In particular, these purported lessons ignore the state and its agents – the ultimate source of the distemper of our times. Similarly, they do nothing to strip mainstream economists of their authority or to reveal their intellectual and moral bankruptcy; as a result (and again in Schiff's words), they "permit governments to pretend that they have the power to dispel hardship with the whir of a printing press, and voters to believe that they can have recovery without sacrifice."

If they are to learn real lessons, then investors as a group must dig much deeper, and confront, reject and replace some of their most precious assumptions. Most fundamentally, they must acknowledge truths about their rulers and the great damage they have wrought and continue to wreak. If investors don't repudiate their worship of the state, and don't recognise that politics is not their salvation, they'll continue the old habits and repeat the same errors.

These truths are as powerful as they are simple. One is that if you or I commit theft, it's called stealing and is rightly condemned. But when the agents of the state steal, it's called "taxation" or "fiscal policy" or "redistributionist policy," is hailed as a bulwark of "social justice" and its proponents are lionised as "compasssionate." Another truth is that if you or I counterfeit, it's called fraud and is rightly punished; but when central bankers do it, it's called "monetary policy," is applauded as an essential condition of financial and economic stability and its conjurers (like Alan Greenspan) are deified. A third truth is that if you or I commit mass murder, we're rightly loathed and damned. But when politicians and military commanders order their henchmen and underlings to shoot and bomb, it's called "foreign policy" and its practitioners are celebrated as heroes.

Is there one moral code for private people and businesses (which forbids theft, fraud and murder), and a diametrically different one for the agents of the state (which requires stealing, counterfeiting and mass killing)? The evil Richard Nixon asserted in 1971 that "when the President does it, that means that it is not illegal." Do you agree? If not, then logic forces the conclusion: government is evil. As Murray Rothbard concluded in The Ethics of Liberty (1984),

> If, then, taxation is compulsory, and is therefore indistinguishable from theft, it follows that the State, which subsists on taxation, is a vast criminal organisation far more formidable and successful than any "private" Mafia in history. Furthermore, it should be considered criminal not only according to the theory of crime and property rights as set forth in this book, but even according to the common apprehension of mankind, which always considers theft to be a crime.

Further, as Rothbard put it in For a New Liberty (1973),

> For centuries, the State (or more strictly, individuals acting in their roles as "members of the government") has cloaked its criminal activity in high-sounding rhetoric. For centuries the State has committed mass murder and called it "war;" then ennobled the mass slaughter that "war" involves. For centuries the State has enslaved people into its armed battalions and called it "conscription" in the "national service." For centuries the State has robbed people at bayonet point and called it "taxation." In fact, if you wish to know how libertarians regard the State and any of its acts, simply think of the State as a criminal band, and all of the libertarian attitudes will logically fall into place (see also Our Enemy, the State by Albert Jay Nock and History + Comedy = Rothbard by Bryan Caplan).

From the Non-Aggression Axiom and a handful of other *a priori* propositions[5] springs the Austrian School of Economics; and from the Austrian School follow a series of harsh but indispensable lessons for today's investors.

Lesson #1: Private Property Is a Necessary Condition of Civilisation

Private property, as the Austrian School has demonstrated from first principles, is a naturally-arising relationship between human beings and material things. Property and enforceable rights to it enable economic calculation, a wider and more dynamic division of labour and therefore increasing levels of prosperity.[6] Indeed,

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[5] Most importantly, human action is an actor's purposeful pursuit of valued ends with scarce means; nobody can purposefully *not* act; every action intends to improve the actor's subjective well-being above what it otherwise would have been; a larger quantity of a good is valued more highly than a smaller quantity of the same good; satisfaction earlier is preferred over satisfaction later; production must precede consumption and what is consumed now cannot be consumed again in the future.

[6] Although Austrians have derived this truth from first principles, it has been known for centuries. As William Bradford wrote in Of Plymouth Plantation (1620-1647), "At last after much debate of things, the governor gave way that they should set corn everyman for

without private property civilisation is inconceivable, and *any* encroachment upon property reduces liberty as well as prosperity (see in particular Liberty and Property by Ludwig von Mises and also Letter 77).

Alas, the mainstream – and, as a result, most actors in financial markets – rejects this essential truth. Economists of the Chicago School, for example, agree that property is central to prosperity and economic growth. But, they allege, it does not arise naturally; rather, they say, it is a product of the legal system – which to them is a creature of the state. For this reason, they insist, it's imperative that the state maintain, modify (and, where necessary, suspend or remove) private rights over property such that transactions costs promote maximum economic efficiency and growth. Accordingly, if your property lies along the path of a proposed railway, and if the state's agents decide that the railway will serve the interests of efficiency more than your use of the property will, then your rights go out the window.[7] Keynesians, too, grudgingly grant that property is important. But its status, they contend, is contingent. In particular, it must be subject to regulation and yoked to the "general good" (of which the state, of course, is the arbiter). Hence the Keynesian insistence that the state must intervene in order – among many other things – to restrain the owners of property; that is, to prevent abuses (as the state defines them) of economic power.

Clearly, then, the trouble with the mainstream is not just that it is wrong: it is pragmatic (see also footnote #2). In their world, a "successful" politician or bureaucrat requires a finely developed sense of rat cunning. And so, apparently, it must be in financial markets: a successful operator is so because he finds a favourable trend and stays there as long as it remains. Never mind if the trend's

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his own particular … That had very good success for it made all hands very industrious, so much [more] corn was planted than otherwise would have been …The experience that has had in this common course and condition, tried sundrie years, and that amongst Godly and sober men, may well evince the Vanities of the conceit of Plato's and other ancients, applauded by some of later times; that the taking away of propertie, and bringing into commone wealth, would make them happy and flourishing, as if they were wiser than God" (see also Tom Bethell, *The Noblest Triumph: Property and Prosperity Through the Ages* (St Martin's Press, 1998).

[7] Relying upon such hyper-utilitarian principles, associates of the Chicago School such as Richard Posner (who is the darling of the "public choice" movement) have advocated the police state. Posner has also, in effect, endorsed slavery. In his eulogy for Milton Friedman, he criticised Friedman's uncompromising (and highly praiseworthy) opposition to conscription. According to the crazed Posner, there are circumstances in which the state's desire to raise a massive army would make it more efficient to impose conscription than to raise taxes enough to pay a wage sufficient to induce enough people to volunteer to kill and maim and die. Typical of Posner (and of the public choicers and Chicago School more generally), the morality of the draft (not to mention the taxes), and the question of whether a draft will encourage the state to wage more wars than if it relied upon volunteers, is irrelevant. For Posner and his ilk, the paramount concern is the most "efficient" way for the state to achieve its ends. This insane position invites the obvious riposte: are there circumstances where it's more "efficient" for a private employer to use slaves rather than to pay a market wage?

motive force is the fraudulent creation of funny-money by the central bank, aided and abetted by commercial banks and the Treasury, which artificially depresses interest rates – and thus artificially inflates the prices of assets. The successful operator does not object; indeed, he neither knows nor cares. Only when prices fall does he give a damn – and then squeal like a piglet for bailouts, lower interest rates and more of the interventions that cause trouble in the first place.

Many actors in financial markets are unprincipled in the sense that they do not operate day-to-day with an eye towards what is right and wrong. Mainstream economics and finance are veritable citadels of expediency. A particularly egregious example occurred in America in 1933. At the behest of the evil Franklin Roosevelt, Congress rendered gold clauses (that is, contracts stipulating payment in gold) null and void. Outraged creditors took Congress to court; the matter eventually landed in the Supreme Court's lap; and in 1935 the Court rewarded FDR and punished widows and orphans.[8]

How did investors react to this matter of utmost importance to the integrity of money and the sanctity of contract? Those who opposed the nationalisation of money, the state's abrogation of valid private agreements and the high-handedness of this fiat act by the Congress found themselves on the wrong side of history – and on the wrong side of the market. During many subsequent episodes, main-

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[8] According to Justice Stone, speaking for the majority in Perry v. United States, 294 U.S. 330 (1935),

> There is no question as to the power of the Congress to regulate the value of money: that is, to establish a monetary system and thus to determine the currency of the country. The question is whether the Congress can use that power so as to invalidate the terms of the obligations which the government has theretofore issued in the exercise of the power to borrow money on the credit of the United States …
>
> As much as I deplore this refusal to fulfil the solemn promise of bonds of the United States, I cannot escape the conclusion, announced for the Court, that in the situation now presented, the government, through the exercise of its sovereign power to regulate the value of money, has rendered itself immune from liability for its action. To that extent it has relieved itself of the obligation of its domestic bonds …

Justice McReynolds delivered the Court's dissenting opinion:

> The record reveals a clear purpose to bring about confiscation of private rights and repudiation of national obligations. To us these things are abhorrent … The Constitution, as many of us have understood it, the instrument that has meant so much to us, is gone. The guarantees heretofore supposed to protect against arbitrary action have been swept away. The powers of Congress have been so enlarged that now no man can tell their limitations … If the dollar be depreciated to five cents or possibly one, then, through fraud, all Government obligations could be discharged quite simply. Shame and humiliation are upon us now. Moral and financial chaos may confidently be expected.

stream economists and market participants actively applauded immoral outcomes. On 16 August 1971, the day after the evil Richard Nixon imposed wage and price controls and destroyed what remained of the gold standard, market participants cheered and the stock market soared.[9]

Mainstream economics and finance, together with their handmaiden, the welfare state of credit, encourage and reinforce irrationality as well as immorality. If rights to property become blurred, the calculation of risk and reward becomes distorted and people take risks they wouldn't otherwise take. When the government has the final say about the ownership and disposition of property, most people believe – laughably but persistently – that it and the central bank will intervene such that untoward things will not happen. Many people adhere, fanatically and disastrously, to the idea that, thanks to the government's pervasive meddling, the financial downside has been conquered. Yet the state simply cannot wave a magic wand and decree that confidence remain (or, when it has inexplicably disappeared, command that it return). Once upon a time, strictly-enforced property rights, exemplified by a gold standard, prevented massive ructions like the one we see today. Now that money is no longer tied to gold and property is ultimately the state's plaything, governments may indeed have the power to "rescue" everybody – but at the cost of making us all courser and poorer. The state that is powerful enough to restore Peter to solvency will also be arbitrary enough to reduce Paul to penury.

Lesson #2: The Government Mustn't Corrupt Interest

Interest quantifies the higher value of present goods relative to future goods (see, for example, Letter 51). Other things equal, everyone wants to consume sooner rather than later. If the current price of a computer is $1,000, then a claim upon a computer deliverable in one year would currently sell for less (say $900). For this reason, an entrepreneur might today invest $900 in labour and raw materials in order to sell a product for $1,000 in a year's time. The return from this investment derives from the fact that the factors of production represent "claims" on goods for future consumption, and thus their current price is less than their ultimate sale price.

Obviously, the government must not interfere with interest. Rates reflect the subjective premia that individuals currently place upon present goods over future goods (which, in the absence of a free market, no government bureaucrat can possibly know). To countermand these rates is to send false and damaging signals

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9 Bill Gross, the co-chief investment officer at Pacific Management Investment Co. provides another example. As Bloomberg (13 January) reported, he "is urging investor to anticipate which assets will benefit as the government struggles to boost the economy … 'Pimco's view is simple: shake hands with the government' Gross wrote in his commentary this month. 'Make them your partner by acknowledging that their chequebook represents the largest and most potent source of buying power in 2009 and beyond.'" (Chris Leithner, it should be noted, is in no position to protest too loudly: several of the investments he has placed during the past year rely upon similar calculations. They were purchased in anticipation of, and have benefitted from, U.S. Government bailouts.)

to borrowers and lenders and producers and consumers. In the words of Ludwig von Mises (*The Causes of the Economic Crisis*, 1931),

> The appearance of periodically recurring economic crises is the necessary consequence of repeatedly renewed attempts to reduce the "natural" rates of interest on the market by means of banking policy. The crises will never disappear so long as men have not learned to avoid such pump-priming, because an artificially stimulated boom must inevitably lead to crisis and depression … All attempts to emerge from the crisis by new interventionist measures are completely misguided. There is only one way out of the crisis: Forgo every attempt to prevent the impact of market prices on production. Give up the pursuit of policies which seek to establish interest rates, wage rates and commodity prices different from those the market indicates.

Unfortunately, the mainstream strenuously disagrees. Payments of interest, they say, compensate investors for the loss of "liquidity" when they exchange cash for ownership of a business project when they or lend cash for a certain period. The interest rate, in other words, is the price of liquidity. Hence the mainstream regards interest as a monetary phenomenon, not a "real" one (as the classical economists thought and the Austrians later demonstrated). Because it's not "real," they contend, the state can and should manipulate interest at will in order to serve "real" ends. Further, mainstream economists emphasise "confidence in the future."[10] For example, if the rate of interest jumps from 5% to 10%, this does not mean that people have become more oriented towards present consumption; instead, it might reflect heightened anxiety about the economy. As a result, insists the mainstream, the government's manipulation of interest is one of several tools required to smooth economic fluctuations.

Reality, of course, flatly contradicts this conception. Since the middle of 2007, central banks and governments have tried a variety of means to achieve the ends they desire (namely the resumption of the supply of vast amounts of artificial credit on generous terms). They have repeatedly "injected" vast amounts of "liquidity" into banks; purchased securities ranging from RMBS to commercial

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[10] And of course finance journalists credulously follow them. "The Trick Is Confidence," trumpeted a headline in *The Weekend Australian* (17-18 January). "A key risk to the Australian economy and most developed economies," it alleged, "is a crisis of confidence among consumers, investors and businesses." "Confidence is a significant issue," stated one of the economists whom the article cited. "Perception is reality [sic] and there is a real risk that the general doom and gloom produces worse outcomes than can be justified purely on the economic fundamentals."

This is simply babble. The "fundamentals" are that many Australian households and businesses have borrowed and spent too much, saved too little (relative to their borrowing and spending) and thus lived beyond their means. As a result, the relevant shortage is of capital rather than confidence. In a psychological sense what's required is not confidence but its near-opposites: vigilance and doubt. Confidence has bred complacency, which has led to error. Vigilance, on the other hand, promotes enquiry and doubt discourages self-satisfaction; both, as a result, help to mitigate error. Mainstream economists prattle relentlessly about confidence because trust in and loyalty to the state underlies their worldview. The truth is that vigilance and doubt is the price of liberty and prosperity.

paper; nationalised banks, insurance firms and mortgage finance giants; increased the amounts of deposits insured and forced market rates of interest ever lower. Yet nothing has worked as intended, and everything has generated negative unintended consequences. As a result, lenders remain more wary than the state desires, stock markets continue to slide, investors are fleeing to what they perceive as safer havens and seemingly every day dawns with the news that yet another major firm stands on the edge of bankruptcy.

What happens when central and commercial banks, succumbing to pressure from the government and the crowd, connive to reduce rates of interest? They make saving less rewarding and the accumulation of debt less costly. As a result, the amount of genuine credit – that is, credit based upon savings, which is the very stuff required to finance a genuine and healthy recovery – *decreases*. At the same time, given that credit has become unnaturally cheaper, investments and projects that would otherwise get the boot suddenly (and falsely) become appealing. But regardless of the amount of credit created out of thin air, and no matter how low these artificially-set interest rates, real resources do not suddenly become more abundant. In a free market of genuine credit, lower interest rates reflect the actual greater availability of investible savings. But in the mainstream's financial fantasyland (i.e., the corrupted market of ersatz credit), artificially-low rates are the consequence of the funny-money "injected" into the financial system.

Hence what Austrian School economists call "malinvestments." When interest rates are lower than they would be in a free market, investment projects which do not accurately reflect the real state of demand and availability of resources see the light of day. This drives up prices in the sectors where the funny-money flows. Eventually, however, investors realise that their projects are not viable; consumers who clamoured to borrow recognise that they cannot afford what they bought at inflated prices; and financial institutions stagger under bad debts.

If little genuine credit is available today, it's because – thanks to the government, which is moving heaven and earth to prevent the liquidation of the mistakes of the past and is thereby creating even bigger mistakes for today and tomorrow – it's stuck in these malinvestments. In addition, there's little genuine credit because there is little true savings to resupply credit markets. Although they have risen somewhat over the past couple of years, and although households are trying to do the right thing, personal rates of savings rates remain anaemic. Finally, as long as they cannot ascertain who is solvent and who is not, those who have money to lend will remain reluctant to do so.

The lesson is that the questions investors should ask about interest relate not to its level or stability, but to its integrity. From the mid-1990s until 2007, artificially low and stable rates masked the distortions caused by the government's funny-money. Hence investors must regularly ask themselves: given the state's pervasive tampering in credit and financial markets, do the prices of assets and rates of interest

convey accurate signals and sensible information?[11] Acting on them, would individuals make reasonable choices? Or would they undertake "malinvestments" that must be liquidated when the boom inevitably ends? These days, many obsess about the reassuring vagaries spoken by central bankers such as Glenn Stevens, Ben Bernanke, etc. Alas, nobody recalls the bracing and crystal clear words of the Weimar German central banker Hjalmar Schacht. In 1927, with the clouds of bust already forming, he protested: "don't give me a *low* rate. Give me a *true* rate; and then I shall know how to put my house in order."

Lesson #3: The Government Must Keep Its Hands Off Savings!

Saving (which means forestalling current consumption) is essential for the formation of capital, but there is no optimal ratio of saving to consumption that should prevail. In a free society, the extent of saving will depend upon individuals' overall or average rate of time preference; that is, the extent to which people prefer goods sooner rather than later. Individuals may choose consumption over investment or vice versa. Government intervention (e.g., subsidising or taxing savings or consumption or both) skews these choices. In order that the mix properly reflects the most economical choices, government should have no policies or programs toward saving – even in the case of saving for old age.

The mainstream sees problems where none would exist if the government kept its hands to itself. To Chicagoans, there is no investment – and hence no economic growth – without saving. So far, so good. Alas, they quickly lose the plot: precisely because saving is a necessary condition of growth, they allege that the encouragement of saving should be one of the government's priorities. Saving, they say, tends to be a life-cycle phenomenon. Young people, who have extremely high time preferences (that is, place a very high value upon the present and a low value upon the future) save little. Young adults have a somewhat lower time preference. But they also tend to have big mortgages and young children, which limit their saving. Adults with grown children and without mortgages are in a relatively strong position to save, unless (as is becoming more common) Bruce and Kylie return to the nest. And elderly people tend to use the savings accumulated during their working lives to finance their retirements. Miscalculations often occurs, which is why (say the Chicagoans) the government must encourage private retirement accounts, a system that is more efficient than Social Security because it yields higher returns.

The Keynesian view of savings is an epitome of absurdity and illogicality (see in particular Henry Hazlitt, The Failure of the "New Economics:" An Analysis of

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[11] Clearly, this question is usually very difficult to answer. But sometimes – if only investors stand apart from the crowd – it is relatively easy. In Canada in 1999, for example, did it make sense that the market capitalisation of a single telecommunications company should exceed that of the country's entire banking system? In Australia in early 2007, did it make sense that the profits of the country's three largest mining companies, if extrapolated five years into the future, would comprise 20% of the country's current GDP? And today, does it make sense that U.S. Treasury securities retain a AAA rating?

the Keynesian Fallacies). In normal times, they allow, saving is not economically harmful. But during a recession it can cause the economy to spiral downward. Saving reduces consumer spending and may not be translated into investment spending because of investor pessimism. This will reduce total demand and lead to unemployment. One way to correct this is constantly to suppress interest rates below their free-market levels. This will support private investment and stimulate total spending in the economy. Fiscal and monetary managers must implement policies that discourage hoarding and encourage current expenditure. As for saving over the life cycle of individuals, say the Keynesians, "we" need a social safety net that will support people in their older years.

The shocking truth is that contemporary mainstream macroeconomics – in both its Chicagoan and Keynesian variants – recommits basic errors first committed centuries ago and corrected in the 19th century by the Classical and Austrian Schools. The mainstream clings fanatically to the demented belief that credit can somehow be conjured out of thin air or ginned from a printing press, and that "injecting" this credit into markets has only positive but no injurious (let alone ruinous) consequences. But resources can't suddenly appear from nowhere. So the government's funny-money doesn't *create* jobs, swords, ploughshares or anything else: instead, it simply *diverts* land, capital and labour from other uses.

Since the mainstream has forgotten (or never known), it is vital to recall what genuine credit actually is. It necessarily springs from savings, that is, the surplus that remains when people choose not to spend all their earnings but to retain some for a rainy day or later consumption. This delayed claim upon resources can be temporarily offered at a price to other people, who either want to consume something before having the means to do so, or invest resources they don't have in capital goods to increase their production capacity and eventually their profits.

In a free market for credit, interest would find a natural level that matched the supply of savings and the demand for debt. The more people are willing to postpone consumption, the more savings there will be and the lower interest rates will be, thus facilitating investments. Conversely, higher demand for credit will place upward pressure upon rates and encourage people to save. This is how unfettered financial markets co-ordinate the actions of creditors and debtors over time.

Clearly, the vital lesson for investors is that what is needed for sound economic and investment conditions is a free market for savings and capital goods – and not subsidised credit and consumption. Blind Freddy can now see that the "permanent prosperity" that from ca. 1995 to 2007 Australians came to regard as a birthright, and to a considerable extent still do, was to a significant extent artificial. Much more than in the more distant past, since the 1980s Australians have subsisted ever more upon borrowed funny-money; as a result – and bearing in mind a proper definition of interest – they have also lived on borrowed time.

"Investment" encouraged by subsidised rates of interest can continue only so long as central and commercial banks connive to make credit available at artificially low

rates. It is this margin between the subsidised and the natural rate that misleads entrepreneurs and gives their investments the false appearance of profitability. It also hoodwinks consumers and gives their shopping sprees the false appearance of sustainability. When the boom ends, it does not *cause* difficulties: it simply *reveals* the problems that inhere in artificially low rates of interest. The defining feature of booms – and the lesson for investors – is that they are NOT periods of good business; rather, they are irrationally exuberant times when capital is squandered on bad investments.

Lesson #4: No Virginia, There's Simply No Such Thing as "Intrinsic Value"

Physical objects such as bananas and motor cars do not possess intrinsic value. Only a human mind can impute value, and only then do producers and consumers classify them as goods. An object is valuable because there is at least one person who believes that it can satisfy his subjective desires. For example, if a particular root cures cancer but one knows this fact then (assuming that it has no other uses) the root has no economic value and people will not exchange it for money. Value, then, derives from individuals' subjective desires and their beliefs about the properties of a particular item.

Austrians explicate value on the basis of utility alone. Not so the mainstream: the value of a good is determined by the interdependence of supply and demand, or what might be called the interaction of cost and utility. Value, in other words, stems both from subjective preferences and from objective technological conditions; in everyday terms, the value of something is its market price. From this conception spring various harmful absurdities – not the least of which include modern portfolio theory and the other catechisms of contemporary finance.

Value investors think about value in terms that are not Austrian but are much closer to the Austrians than to the mainstream (see in particular Letter 52 and Ludwig von Mises, Meet Benjamin Graham: Value Investing from an Austrian Point of View). Benjamin Graham held that, in every transaction, price is what is paid and that value is what is received; observed that over time price and value tend to gravitate towards one another but that at any given point in time they may diverge (sometimes by a wide margin); and lamented that very few people recognise the fundamental difference between value and price. It is this vaguely-Austrian conception of value and price that distinguishes Graham and his successors from today's mainstream. Value investors thus reject today's dogma that the price and value of a security necessarily coincide at all times.

A price is a ratio at which the "most eager" buyer(s) and "most eager" seller(s) voluntarily exchange some specified good, service or commodity. A buyer is "most eager" in the sense that he is willing to exchange it for the greatest amount of some other commodity such as money. A seller is "most eager" in the sense that he is prepared to accept less money for it than is any other seller. Hence a security's least optimistic present owner and most optimistic non-owner determine its price. In the words of John Burr Williams (*The Theory of Investment Value*,

1938), "the margin will fall between owners and non-owners, the ins and outs, the ayes and nays; and at this margin, opinion, mere opinion, will determine actual price." The price of a stock, bond or other security at any point in time reflects marginal opinion at that time. It follows that a particular price is unique to a given buyer(s) and seller(s), the security being exchanged, their attitude towards it and their information about it. All of these determinants of a security's price are subject to sudden and unexpected change; accordingly, so too is its price.

A stock's price may thus tell us something about the value imputed to it by an eager buyer and an eager seller at a particular point in space and time; but it tells us nothing about the value attributed to it by other owners and by non-owners. Still less does it tell me the value I should impute to it. A stock's price and its value, then, are very distinct things; in any given exchange the one will not equal the other; and current price may differ greatly from my estimate of its value. Only if the current price differs considerably from my own assessment of its value and no better investment opportunity presents itself does this price give me an incentive to act. According to Warren Buffett (*Forbes* 4 January 1988), "the market is there only as a reference point to see if anybody is offering to do anything foolish." He added (*The New York Times Magazine* 1 April 1990) "for some reason, people take their cues from price action rather than from values. What doesn't work is when you start doing things that you don't understand or because they worked last week for somebody else. The dumbest reason in the world to buy a stock is because it's going up."

The price of a security, then, is determined by marginal opinion. But opinions are not the same as facts, and the opinions of marginal buyers and sellers are not necessarily informed opinions. Market participants, in other words, are neither omniscient nor prescient; nor are the prices they set in markets. James Grant puts the lesson tartly in *Minding Mr Market: Ten Years on Wall Street With Grant's Interest Rate Observer* (1993): "to suppose that the value of a common stock is determined purely by a corporation's earnings discounted by the relevant interest rates and adjusted for the marginal tax rate is to forget that people have burned witches, gone to war on a whim, risen to the defence of Joseph Stalin and believed Orson Welles when he told them over the radio that the Martians had landed."

Lesson #5: Governments Caused the Great Depression and (in the U.S.) the New Deal Not Only Failed to Reverse It – It Worsened It

To the mainstream, anything and everything except the government and its central bank causes the business cycle. Booms, its Keynesian wing alleges, begin with excessive optimism, often prompted by technological shifts, resulting in speculative frenzies. Deficient total spending causes recessions. When total savings exceeds total investment, spending on goods and services stagnates or falls. This decreases the demand for the labour to produce these goods. Then pessimism (or what would today be dubbed a "lack of confidence") among businesses and investors leads to insufficient aggregate demand and economic hard times.

What is the correct antidote to recession? Today, Keynesians[12] and Chicagoans emphatically agree: the central bank must "stimulate" the economy through low interest rates, which encourage borrowing and spending, and the government must stimulate it by increasing aggregate demand (i.e., by spending money on anything and everything), even if it results in deficits (see also Chicagoites As Confused As Ever by Martin Masse). That's right: the antidote to living beyond one's means is … living even further beyond one's means! Once the economy gets back on course (as it most certainly will, since interventionism and statism always succeed), the wise men at the central bank will permit rates to rise and the sage souls in the government will curtail spending. In addition to fiscal and monetary measures, say the Keynesians, the government must protect the industries that the recession hits particularly hard. Further, it should protect workers from layoffs and support the unemployed. Consumers should not hoard cash but spend it, and the business sector should freely borrow from both banks and government.

According to Ben Bernanke, the Great Depression began as a conventional business cycle that might have been vanquished through monetary expansion. But Hoover failed to see the seriousness of the situation, and allowed banks to fail. This led to Franklin Roosevelt's landslide election. FDR was right to dismantle the gold standard, but was wrong to institute excessive controls over the economy. The Second World War, and not the New Deal, ended the Depression. Thanks to fiat money (that is, government-imposed money backed not by gold but the full faith in and the credit of the U.S. Government) and an effective Fed that stands ready to intervene, that experience never needs to be repeated.

The Keynesian interpretation is that all market economies occasionally face crises, but Hoover failed to intervene in time and instead pursued a laissez-faire approach. The New Deal was an innovative effort to cope with new economic realities. It boosted aggregate demand in the face of lost public confidence, and employ both fiscal and monetary stimulus to counteract the deficiencies of the market. The New Deal wasn't so much an experiment in economic democracy and planning as an attempt to save capitalism from itself. Where it fell short, national mobilisation and wartime planning succeeded. Keynesians conclude that active and perhaps unprecedented fiscal and monetary policy measures are essential to stabilise the inherently-unstable market economy.

The preceding four paragraphs are, of course, complete nonsense. As the great Murray Rothbard put it in Economic Depressions: Their Cause and Cure,

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[12] The absurdity of John Maynard Keynes and his followers simply cannot be underestimated. Keynes did NOT write this passage (from *The General Theory of Employment, Interest and Money*, 1936, p. 129) tongue-in-cheek: "If the Treasury were to fill old bottles with bank-notes, bury them at suitable depths in disused coal-mines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of laissez-faire to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no more unemployment and, with the help of repercussions, the real income of the community, and its capital wealth, would probably become a good deal greater than it actually is."

> It is the preceding inflation that makes the depression phase necessary. The depression is the process by which the market economy adjusts, throws off the excesses and distortions of the previous inflationary boom, and reestablishes a sound economic condition. The depression is the unpleasant but necessary reaction to the distortions and excesses of the previous boom. The business cycle is brought about, not by any mysterious failings of the free market economy, but quite the opposite: By systematic intervention of government in the market process. Government intervention brings about bank expansion and inflation, and, when the inflation comes to an end, the subsequent depression-adjustment comes into play … what the government should do, according to the Misesian analysis of the depression, is absolutely nothing.[13] It should, from the point of view of economic health and ending the depression as quickly as possible, maintain a strict hands-off, "laissez-faire" policy. Anything it does will delay and obstruct the adjustment process of the market; the less it does, the more rapidly will the market adjustment process do its work, and sound economic recovery ensue. The Misesian prescription is thus the exact opposite of the Keynesian: It is for the government to keep absolute hands off the economy and to confine itself to stopping its own inflation and to cutting its own budget.

The Great Depression was the very unpleasant but absolutely necessary consequence of the distortions and excesses of the previous boom – and of the frenzied interventionism after 1929. America's stock market crash represented the most visible sign of a correction in an economy that had been artificially inflated by expansionary monetary policy. Unfortunately, instead of allowing the necessary and salutary liquidation, the great humanitarian and engineer but hopeless economist, Herbert Hoover, attempted to resuscitate the economy through interventionist measures (including protectionism) which drove it further into the ground. FDR built upon this sorry record and embarked on a disastrous course of even more comprehensive central planning. The Second World War did not reverse the Depression, and the economy didn't fully recover until many controls were lifted or abandoned after the War.

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13 The mainstream, it seems, has (perhaps wilfully) misunderstood this point. By "do nothing," Rothbard and Mises meant "abandon the interventionist policies that caused the depression." As Ron Paul has said (Ron Paul Has Nothing Good to Say About the Wall Street Bailout Plan, *The Los Angeles Times*, 21 September 2008), "that doesn't mean you [do literally] nothing. I mean, we could reform the system. We could return to sound money. We could balance our budget. We could change our foreign policy. We could take care of our people at home. We could lower taxes. There's a lot of things that we can do. But the worst thing that we can do is perpetuate the bad policies that gave us this trouble in the first place, and that is that we no longer, over the last quite a few decades, [believe] in free-market capitalism … And you can't solve the problem of inflation, which is the creation of money and credit out of thin air, by [conjuring] more money and credit out of thin air. We have to change basic policy … What they're doing now, they're propping up a failed system so the agony lasts longer. They're doing exactly what we did in the Depression. What the government is doing now … is trying to prop up prices. You want the price structure to adjust. You want the price of houses to go down. You don't want to fix the price of housing. You can't price-fix. We've had too much of that."

Economists who possess a detailed knowledge of history understand that the prescriptions peddled by today's mainstream, which reprise those of the 1930s, are making and will continue to make matters worse. As theatre, propaganda and a vehicle for FDR's ambitions, the New Deal was a spectacular success; as economics, it was a dismal failure. In an address to Congressional Democrats in May 1939 – that is, after almost a decade of Hooverveltian interventionism – the U.S. Treasury Secretary, Henry Morgenthau, frankly confessed its abject failure. He thereby foretold the direction in which today's anointed are leading the benighted:

> We have tried spending money. We are spending more than we have ever spent before and it does not work. And I have just one interest, and if I am wrong … somebody else can have my job. I want to see this country prosperous. I want to see people get a job. I want to see people get enough to eat. We have never made good on our promises … I say after eight years of this Administration we have just as much unemployment as when we started … and an enormous debt to boot!

Almost seventy years later, *plus ça change, plus c'est la même chose*. Then, politicians and bureaucrats could not flout the laws of economics. Nor can they do so now. Memo to President O'Babble: no, you can't (see also The Obama Stimulus Plan Won't Work by Dom Armentano and Obamanomics Will Fail the American People by Michael Rozeff). Poor policies produced the Crash of 1929, and even worse interventions turned it into the Great Depression. Statism has caused today's mess, and more intensive statism ("the audacity of debt") is broadening and deepening it. Australia's Prime Minister has repeatedly vowed to do "whatever it takes" – except, of course, abandon the failed policies of the past. The lesson, then, is crystal clear: unless he has compelling grounds to do so,[14] no sane person should ever believe anything that any politician or mainstream economist or journalist ever says.

Putting the Recession, Bear Market and Bankruptcy to Good Use

"Liquidate labour, liquidate stocks, liquidate the farmers, liquidate real estate, [liquidate the bankers and businessmen and above all the government]," Andrew Mellon, Herbert Hoover's Secretary of Commerce, sagely counseled his boss. "It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people …" Alas, Hoover rejected this sound advice and turned a short-but-sharp recession into the Great Depression. Yet despite Hoover's and Roosevelt's frenzied efforts to forestall it, labour, land and capital *did* liquidate; values *did* adjust; once the government unchained them, entrepreneurs *did* rejig the structure of production – and, as a result, America *did* return to prosperity.

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[14] Will wonders never cease? We're not in Kansas anymore, Dorothy, when an article in *The New York Times* makes good economic sense. See Where Sweatshops Are a Dream by Nicholas D. Kristof.

Clearly, we're still in the stage of liquidation and of adjustment of value – which, once again, governments are frantically but vainly resisting. During 2008, some of Australia's wealthiest families and individuals were reduced from riches to – well, hardly rags, but considerably fewer riches (see Annus Horribilis by James Thompson and James Packer Is Losing $6000 a Minute by Paul Barry). Similarly, the results and reputations of acclaimed funds managers have taken a severe beating. According to *The Wall Street Journal* ("The Year of Wall Street's Fallen Idols," 14 November), "Marty Whitman, the legendary septuagenarian who co-manages Third Avenue Value, has seen crises come and go. There are few you could trust more in a panic. But his fund has almost halved this year. Bill Miller, the famous manager at Legg Mason Value, has fallen by nearly 60%. And that's not even the worst of it. Miller's more flexible, go-anywhere fund, Legg Mason Opportunity Trust, is down by two-thirds since the start of the year."

Investor	Vehicle	One-Year Return (to 31-10-08)	Five-Year Compound RR (to 31-10-08)
Tweedy, Browne	Tweedy, Browne LLP	-41.3%	3.2%
Warren Buffett	Berkshire Hathaway	-30.3%	7.1%
Chris Davis	Davis Advisors	-50.1%	3.5%
William Miller	Legg Mason Value Trust	-62.9%	4.5%
Mohnish Pabrai	Pabrai Investment Funds	-67.0%	n.a.
Ruane Cunniff	Sequoia Fund	-53.8%	7.3%
Martin Whitman	Third Avenue Value Fund	-61.6%	11.8%

Source: gurufocus.com

Even Mr Buffett and Berkshire Hathaway have had a tough time. In September, he bought a $US5b swag of Goldman Sachs preference shares, received a yield of 10% and, for next to nothing, a pile of warrants with a strike price over the common stock of $115. He explained his reasoning to the broadcast media and expressed his views in print (see Warren Buffett, Buy American. I Am, *The New York Times*, 16 October). Many took heart. "Warren never gets it wrong, does he? Things may look bad, but he's buying so it must be good."[15] By November the price of Goldman common had fallen to $55, and the preferred to $9. In little more than two months, Buffett had incurred an unrealised lost of nearly 50% on this investment. Also in 2008, Berkshire recorded four consecutive declines of profit (the worst streak in more than a dozen years) and its stock slid 36% (its steepest fall in 30 years).

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[15] See, however, Even the Oracle Didn't Time It Perfectly by Peter Eavis; Leave Stocks to Buffett (For Now) by Bill Fleckenstein; and Buffett Is Wrong: The Market Madness Is Still Far From Over by Jennifer Hill.

These developments need not be bad news. If they cause consumers, taxpayers, businessmen and individual and institutional investors to rethink their premises and world-view, to shed the smelly robes of statism and don the clean cloak of liberty, then they contain the seed of much good. When dispassionate people think of capitalism, they tend to think of diligence, thrift, sobriety, profits and the steady (but hardly uninterrupted) accumulation of capital. But one of the major benefits of the free society is its ability to generate losses and business failures. And just as politicians can't sleep well knowing that profits are distributed unequally, they can't bear the thought of business failure. Yet both profit and loss have social and economic merit; as a result, both must be allowed to take their natural course (see In Praise of Bankruptcy by Henry Thompson and In Praise of Failure by Lew Rockwell).

Although its effects can take years to become fully visible, any attempt to ignore or evade losses eventually causes immense damage. Protectionism is a textbook example. Businesses that haemorrhage money may attempt to shield themselves from foreign competitors by lobbying the government to maintain at an artificially high level the prices consumers pay for goods and services. These higher prices are a form of taxation, and the protected industries receive the proceeds. Antitrust (in Australia, "competition policy") is another example. It's a form of regulation that defends the firm that serves its customers relatively badly. The germ of most antitrust cases is a poorly-managed business that seeks redress against better-managed and more profitable rival.

The worst and most numerous examples of failed industries appear in the coercive ("public") sector. The Soviet economy was an ultimately doomed effort to keep failed industries on the drip-feed. Are Western democracies so different? Members and leaders of cargo cults maintain that manufactured goods ("cargo") have been created by spirits (deities and ancestors) and are intended for the local indigenous people; unfairly, however, foreigners have (through malice or mistake) gained control of these objects. Members, leaders and prophets of the cult of social democracy insist that educational, medical and other goods and services are created by spiritual means (such as Keynesian fiscal policy), and are intended for the cult's members, but that, unfairly, capitalists have somehow prevented the proper flow of these objects to members. Cargo cultists believe that if they build models of aeroplanes and recreate aerodromes, the "cargo" will return. Social-democratic cultists' clamour for bailouts, "stimulus packages" and infrastructure "investments" stems from the equally primitive belief that consumption causes prosperity (see Cargo Cult Economics by David Calderwood).

Why do businesses fail? Many reasons. Their owners and managers fail to discern changes of market conditions and consumers preferences, or they fail to anticipate changes in resources and tastes. Poor stewardship can sink a company; so can aggressive competition from companies who were drawn to a market segment in hopes of sharing the profits. "Greed works," said Gordon Gekko in "Wall Street" (1987). "Greed clarifies … and cuts through." The same is true of investment losses and business failures. They clarify reality and concentrate the mind.

The Fringe Benefits of Failure

In her commencement address (June 2008) to the graduates of Harvard University, entitled The Fringe Benefits of Failure, and the Importance of Imagination, the British author, J.K. Rowling, recounted the importance of failure to her success. "Failure meant a stripping away of the inessential. I stopped pretending to myself that I was anything other than what I was, and began to direct all my energy into finishing the only work that mattered to me. Had I succeeded at anything else, I might never have found the determination to succeed in the one arena I believed I truly belonged."

Attitudes towards failure differ around the world. In many parts of Asia, failure, however honestly and even honourably achieved, seems to be regarded with shame and scorn, and is often hidden from family and friends. Western countries, particularly in Europe, have tried (vainly, of course) to outlaw it. Social welfare systems purport to protect citizens from economic, financial and other vicissitudes. Of course, failure is hardly an experience that one should deliberately seek, and it makes sense to cushion oneself against its harshest blows. Equally clearly, it's self-defeating to despise it. Failure gave Rowling "an inner security that I had never attained by passing examinations. Failure taught me things about myself that I could have learnt no other way." Like cod liver oil and coronary by-pass surgery, failure is quite unpleasant when it's experienced; upon reflection and in hindsight, however, it can also be quite beneficial (see also What's Wrong With Failure? by Jeffrey Tucker).

Many scientific "failures" have subsequently generated positive – and sometimes spectacularly successful – results. In the 1830s, scientist Charles Goodyear sought to make rubber the industrial material of the future. Enlisting the help of family, friends and anyone else who would contribute funds, he spent more than a decade developing the process of Vulcanisation. Potential investors laughed at him, and on several occasions disgruntled creditors imprisoned him (he conducted some of his first experiments from his gaol cell). After many failures came an accident: he spilt a concoction of rubber and other materials upon a hot stove – and discovered a mixture that could withstand extremes of temperature. Hence the basis of the tyres sold by Goodyear, a firm with which he had no connection but was named in his honour. Similarly, Viagra, one of the most successful drugs of all time, was first regarded as a fizzer. In 1992, Pfizer was testing a drug (sildenafil) for the alleviation of angina. Researchers discovered that it didn't relieve pain very much, but it did put a rocket under libidos. Pfizer's failed angina medication launched a multibillion-dollar industry.

Failure in business is much more common than success. No matter how doggedly the mainstream denies it, capitalism is all about the satisfaction of customers, and those who don't love their neighbours fall by the wayside. What seems to differentiate the survivors is their application of the knowledge they gain from failure. Henry Ford – who endured bankruptcy several times before launching Ford

Motor Co. – once stated that "failure is simply the opportunity to begin again, this time more intelligently."[16]

Benjamin Graham provides an excellent example. On the eve of the Crash of 1929, he managed what we in the 21st century would regard as a hedge fund. He was "long" $2.5m of stocks and bonds, and "short" the same amount. As a result, those positions (considered as a whole) were not unduly exposed to any change of the prices of the underlying securities. In addition, however, he owned $4.5m in outright long positions, and had incurred substantial margin debt in order to own them. In his posthumously-published memoir, entitled *Benjamin Graham: The Memoirs of the Dean of Wall Street* (1996), the father of value investing described his state of mind at the time: "We were convinced that all of our long positions were intrinsically worth their market price." But there's no such thing as intrinsic value. And by mortgaging himself, Graham unwittingly transformed a conservative stance into a risky one. From the top to the bottom – that is, from 1929 to 1932 – his fund fell by 70%. That was a better showing than the 87% drop of the DJIA (today's funds managers might exult at his "outperformance"), but Graham never pretended that it was anything other than a calamity.

Yet he persevered. By 1936 he had recouped his losses – only to incur more in the "Depression-within-a-Depression" of 1937-38. Still he persevered. Not only did he eventually achieve an excellent record – including the disastrous years – he also wrote *Security Analysis* and *The Intelligent Investor*. We've all heard the platitude, "The first rule of investing is not to lose money and the second rule is not to forget the first." That's reasonable, but hardly inspirational. What does inspire is Graham's career, which shows that a debilitating loss is no reason to capitulate. Sooner or later, almost everybody experiences a major failure. Indeed, a life devoid of failure is something other than a full life. As Rowling advised last year's Harvard grads, "It is impossible to live without failing at something, unless you live so cautiously that you might as well not have lived at all – in which case, you fail by default." So if at first you don't succeed, try again. Strive, in other words, to fail better next time. The premises, logic and conclusions of the Austrians, and the methods of Graham, provide a solid basis for more successful failure.

Chris Leithner

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16 Bless him, Ford was a stoic liquidationist from the Mellon mould. No bailouts for him – or anybody else. On 11 February 1934, he thundered: "Let them fail; let everybody fail! I made my fortune when I had nothing to start with, by myself and my own ideas. Let other people do the same thing. If I lose everything in the collapse of our financial structure, I will start in at the beginning and build it up again."