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A Stern Approach

I have often observed how the past is ever-present and that history – which is, after all, the study of human nature too – is the most reliable guide for making predictions; especially those connected with investments. William Faulkner, the American Nobel Prize Laureate, was right: "The past is never dead. It's not even the past."

I have no interest in numerology beyond the sure visual certainty of the number 8 as the ebb and flow of repetition prevails. Even when the figure – eight cycle of events (a constant of my writing) pushes history to one side during a period of complacency, it is sure to return and haunt us, like the ghost of Hamlet's father, yet again. Consider this prediction:

"It will of course in the first place lead to many upsetting changes throughout the economies of the Western world including an avalanche of bankruptcies or similar financial difficulties but it will result in a long overdue purge and after excessive expansion in many wrong directions there is a good chance of more sober attitudes evolving and expressing themselves in constructive actions. It will be a very slow development but I believe sounder conditions may ensue than those from which we have suffered in recent years."

You would be forgiven for thinking that this sombre judgement was made recently by an economist surveying the sick economies around him or, alternatively, a contrite banker wearing sack cloth repenting his transgressions following the profession's fall from grace. You would be wrong; these were the views of the late Sir Siegmund Warburg, the consummate banker who regarded his profession as a calling, and were given nearly half a century ago during the economic turmoil of the 1970s. Surely today we all identify with the references made by him to a long overdue purge, excessive expansion and an avalanche of bankruptcies?

In 1831 Samuel Taylor Coleridge, in picturesque prose, made the point:

"If men could learn from history
what lessons it might teach us!
But passion and party blind
our eyes, and the light which
experience gives is a lantern on
the stern, which shines only on
the waves behind us!"

Although Siegmund Warburg's great interest was graphology, he didn't need it to read the writing on the wall. The late London banker personified relationship banking (his particular interest was human relations) and in the 1960s he served as an economic adviser to the United Kingdom's prime minister. He had arrived in the City of London as an apprentice banker in 1926 and eventually he was instrumental in creating Eurobonds (debt denominated in a currency differing from that of the country where it is issued). Accuracy and honesty were a given and here was a man who called a worker on Christmas Day to complain that there was a comma missing after one word in the fifth paragraph of a three-day old note on the American stock market.

Putting aside his powers of observation, it has become rare to see such devotion to correctness today as the use of e-mails and text messages in business marches on and good spelling and grammar are the first casualties.

Bringers of Dreams

What is also ever-present, defying my figure eight is the confidence trickster; he is constant, rather than cyclical, and so there is no respite from his machinations.

Homer, poet of the Iliad and the Odyssey, wrote about Hermes who was the herald of the Olympian gods as well as the Greek god of commerce and was said to be full of tricks and a bringer of dreams. Today he is emulated by the conmen who count on a steady flow of fools all year round. Those who use offshore financial services centres in particular should bear in mind what Mark Twain had to say about April Fool's Day, and which is just around the corner: "the day we remember what we are the other 364 days of the year".

In the 14th century, magicians had their own bible called Secretum Philosophorum which included an explanation of how to turn water into wine by soaking pieces of bread in dark wine and then drying them in the sun. Subsequently the bread could be dropped, unseen, into a jug after which the "miracle" could take place. The spinners of tales today can be equally absorbing, but in a different context; they have been able to become more adept at their black art because of the greater resources and corresponding degree of sophistication at their disposal.

It is wrong to assume that only the gullible are in danger; just because people are brilliant doesn't mean that they can't be bamboozled. Far from it. This often arises, with or without duplicity, when a person doesn't understand fully what he is getting into. Those venturing offshore for the first time be warned and the ridiculous beliefs drummed into people about offshore structures where selected or doctored pieces of information, rather than a magician's bread, are used are a continual source of amazement for me. I know, however, from the steady stream of walking wounded who have entered through my office door over the years that when misinformation and malevolent manipulation are combined, the results can be toxic.

Enron Corporation, the American energy company, still remains a shining example of ignorance and chicanery that ensnared so many in its web of deceit, including lobbyists and consultants, who didn't fully understand and failed to do the proper research. Jeffrey Skilling, Enron's chief executive, was known as a dismissive boss; he publicly berated investment analysts who questioned his complex accounting methods. Enron, in fact, made any meaningful research into the depths of the company's operations so daunting that a large number of analysts did not attempt the journey. It was not that they were below-average in intelligence, it was simply because they were insufficiently qualified to understand the accounting; it would also be fair to say that others were either just not aggressive enough, failing to obtain adequate information, or were prepared to place their professional reputation on the line for generous fees. Those of us who are grey beards in business understand that no remuneration can replace loss of reputation.

There is a postscript to this Enron story that remains current. Those readers of my column, Latin Letter, will recall Peacocks on Parade (December 2012 issue) and Watch with Glittering Eyes (published last month), both being a two-part commentary which highlighted Delaware, the state in the United States of America where unrivalled corporate secrecy is available. A former head of Delaware's Division of Corporations argues that "Non-public companies have very good reasons why they don't want to disclose who the owners of their businesses are. It's one of the things that makes our economy run well". Try that defence before a senate committee in Washington if you come from an offshore financial services centre. Enron set up an international web of companies in 62 countries and 23 US states that frustrated investor scrutiny; but the largest number of subsidiaries (685, not counting duplicate names) were established in Delaware. I addressed the state's transparency record when I chaired this month's Offshore Investment conference in Panama during a talk entitled: Secrecy – is it dead? It isn't in the case of corporate affairs which can be conducted from plush offices in the world's capitals far from prying eyes.

Handguns, Wolves and Snakes

Even absent bad faith, not understanding and relying on others can be costly. Long-Term Capital Management, the hedge fund which caused calamity in 1998, is a classic case of this. The hedge fund had $80 billion of assets and enjoyed a spectacular 4 years of success until the economic collapse of Russia. The fund's success, in broad terms, had been the result of complex mathematics applied to discrepancies in value between different bonds and derivatives. Eventually, however, after paying out billions of US dollars in collateral on loss-making positions, its capital was wiped out.

The firm had been led by John Meriwether, a legendary Wall Street figure, who recruited not only stellar traders but distinguished academics to deal with the mathematical analysis. Some of his partners had studied at the Massachusetts Institute of Technology and Harvard Business School; two of them, Robert Merton and Myron Scholes, had won the 1997 Nobel Prize for economics for their pioneering work on option pricing.

Science's contribution to finance probably began in Paris with Louis Bachelier who died in 1946 and who gave birth to mathematical finance. He drew up the first scientific model of how market prices change with time; his "random walk" model was, in fact, a walk on the wild side because it was far from reality, much like the garden path along which LTCM investors were led.

Investors were only given sketchy details of the investment strategy and the specifics were not forthcoming. Part of the investment strategy called for the use of computer models and as the journalist Mitch Radcliffe has argued, a computer lets you make more mistakes faster than any other invention in human history, with the possible exception of handguns and tequila.

The fact is that many of the private individuals and financial institutions who poured money into LTCM were mesmerized by its assembled body of talent and skill. In fairness, in its first 31 months of operation the fund achieved an annualised 48.3 per cent return to investors, according to Institutional Investor magazine. But, crucially, the sources of this achievement were not understood by so many investors and blind faith, rather than business sense, prevailed. In the end the US Federal Reserve had to step in, concerned that the collapse could trigger a wider disaster because the banks and investment houses on Wall Street would be affected by the fund's liquidation. (They didn't know what waited for them around the corner in the 21st century.)

Finally an agreement was reached among 15 financial institutions to bail out the fund. The consortium gained management control of LTCM as well as 90 per cent of its portfolio. Afterwards, Mr. Meriwether, despite having encountered such heavy weather, expressed faith in the fund's future. One banker's response: "Has this guy got any shame? He brings us all to the brink with his black box nonsense..." and added: "That guy is toast."

And so were the hopes and dreams of many investors.

A Spanish proverb says that a wolf sheds its coat but not its vices. As the good times come to Panama (a country whose economy last year grew at a pace unrivalled elsewhere in Latin America) there are many wolves from colder climes swapping coats for Guayaberas. And if you thought Scotland's seventeenth-century Darien exploits on Panama's isthmus were bad enough, you should consider the subsequent investment scheme in the nineteenth century created by Gregor MacGregor in present-day Honduras where the mystical, but fictional, country of Poyais lay (I will be writing again in greater detail on this subject). Like investors today, the search for higher yield in a low-yield world tempted people and many became easy prey for the unscrupulous.

This may be the Year of the Snake for the Chinese but for all investors the snake in human form is, like history, ever- present regardless of which year it is. Like the wolf, the snake sheds its skin but not its character and its serpentine nature. Whether its investments or the dishonesty of others, it is a sad fact that Coleridge's lantern will still shine behind for most of us.

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