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Components of Prosperity

By Michael Milken

A recent book about financial markets said “real estate prices collapsed, credit dried up and house building stopped.” That’s not a description of 2008 or 2009. It refers to 1792, during the administration of George Washington. More recently, stock markets dropped sharply, banks curtailed lending and unemployment rose to double digits. That was 1974.

Live long enough and you begin to appreciate what remains constant through cycles of history. More than 40 years ago as a student at Berkeley and then at Wharton, I developed a formula for prosperity that applies in any economic cycle:

$$P = Ft (HC + SC + RA)$$



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It says that prosperity equals the effect of financial technologies acting as a multiplier on the total value of human capital, social capital, and the real assets – cash, receivables, land, buildings, etc. – typically found on balance sheets. Social capital includes educational, cultural, religious and medical institutions and such intangibles as the rule of law and enforceable property rights. Human capital – the largest, most-important asset – is the skills, training and productivity of people.

My academic research in the 1960s had shown that investment in a diversified portfolio of high-yield bonds produced a better return – even through the Great Depression – than investment-grade debt. These non-investment-grade securities were also superior investments than loans to individuals, to real estate or to governments. This became increasingly clear as financial technology was developed and expanded in the 1970s and '80s using such tools as collateralized loan and bond obligations. It’s important to distinguish these innovations – which are backed by the substantial value in operating businesses and have stood the test of time – from securities with less underlying value. An example of the latter would be mortgage-related instruments in a marketplace where both borrowers and lenders are excessively leveraged. Consider some of the differences:

- The 1970s were difficult for many banks and other financial institutions, which struggled with losses related to the first oil shock and the aftermath of a mid-decade recession. As a result, banks had difficulty meeting their customers’ financing needs. But the capital markets began to provide new types of financing

– eventually embracing substantial increases in the issuance of non-investment-grade debt – that expanded access to capital, helped allocate it more efficiently, dispersed risk, stimulated employment and freed businesses from dependence on any particular financial institution. This provided underpinning for equities and has remained a reliable source of financing for growing companies ever since. It was an important factor in the creation of 62 million new U.S. jobs by small and medium-sized businesses over the 20th century’s last three decades.

- On the other hand, many types of mortgage-backed securities have had a less favorable effect. Residential mortgage debt in the U.S. is most often non-recourse – if the borrower fails to pay, the lender cannot look to any assets beyond the underlying property for satisfaction of the debt. (This contrasts with most other industrialized countries where the creditor’s collateral includes other assets and income.) In the 1980s, falling commodity prices devastated real-estate markets in “oil-patch” states such as Texas, Oklahoma, Arkansas, Louisiana and Colorado. In Houston, for example, home prices declined 40 percent between 1983 and 1988. Within a few years, every major Texas bank (some of which had been rated AAA) either failed or was absorbed by another institution after a sharp spike in foreclosures.

In the past few years, the list of highest-foreclosure states changed, but the result was similar. Lenders ignored financial history and did not adequately account for the risk of a housing slump in their underwriting practices. They apparently forgot that in 50 of the 120 years since 1890, U.S. real estate prices have fallen. Government-sponsored enterprises kept buying mortgages where the borrower had little or no equity. Rating agencies largely ignored the risk when evaluating mortgage-related securities. Many investors continued to buy securities based on these ratings rather than an understanding of their complex structures. It should have been clear that no matter how securities are structured, if the underlying mortgages lack value, no amount of repackaging will improve them.

Greater understanding about the history and nature of credit could help reduce the length and depth of future global downturns. Six points are particularly relevant:

1. Credit is what counts, not leverage. In recent years, many of the world’s largest financial institutions were leveraged 30-to-1 or even higher. That is simply not a business because with such high leverage, no one is smart enough to withstand the volatility of financial markets. Over the long run, the best way to maximize profitability is not to increase leverage, but rather to analyze credit properly.

2. Real-estate loans are rarely high-quality investments. If property prices rise, the borrower keeps the gain; if prices fall, the borrower may walk away, leaving the lender with a long-term depreciating asset; if interest rates rise, the value of the loan declines; and if interest rates fall, the borrower can prepay. Residential mortgages not only lack the call protection of most bonds and other debt instruments backed by business assets, they also lack the liquidity of securities. Thus, an investor can sell 3,000 shares of IBM stock – worth about \$400,000 – in less than a second with a transaction cost under \$10; but a \$400,000 house in foreclosure takes months to sell with fix-up costs, commissions and legal fees that can exceed \$30,000.

3. Interest rates are never predictable over time. In 1981, for example, every major financial institution was essentially under water on a mark-to-market basis because rate increases on AAA assets produced more than \$1 trillion in unrealized losses.

4. Credit research should go far deeper than ratings, which have not been a good predictor of credit quality across different industrial sectors. In recent years, investors purchased hundreds of billions of dollars worth of AAA-rated mortgage-backed securities that in reality were never close to AAA quality. Without high ratings, most of these transactions would not have occurred.

5. The risk in sovereign and government debt has been dramatically underestimated for centuries. Governments around the world have regularly defaulted on their debts. Those that didn't default often hyper-inflated their currencies, which had a similar effect.

6. The value of debt securities is the underpinning of all capital markets. As we've observed in the last year, when the yield spread on corporate debt decreases, the value of equities rises. On a global basis, 2009 was the third-greatest year for wealth creation in history as public and private markets provided the capital for economic recovery – just as they did in the late 1970s. Even as markets recover, however, it's important to remember the downturn's human impact. Financial recovery does not automatically translate into a jobs recovery. Millions of people worldwide have suffered, in part because of a misallocation of capital. Relief for them depends on financing the small and medium-sized businesses that are best able to create jobs.

Although credit is a powerful economic force, prosperity requires something more, something that doesn't appear on corporate balance sheets – human capital. That's why, in financing growing companies, I always looked beyond balance-sheet numbers to the quality of management, especially its vision and entrepreneurial drive.

When we established the Milken Institute two decades ago, its full name – the Milken Institute for Job & Capital Formation – recognized the value of human capital. The concept is central to the Milken Institute Global Conference, which brings 3,000 leaders from 60 nations to Los Angeles each spring to exchange ideas on developing solutions to important social challenges. (More information is at www.milkeninstitute.org.)

Looking back over more than four decades, it's clear that properly implemented financial technology, strongly backed by business assets, has strengthened access to capital and job creation. Yet time and time again, problems emerge from a failure to heed the lessons of history. The recent market turmoil would not have occurred without unrealistic ratings, excessive leverage, government actions that distorted markets and the persistent fallacy that all loans to real estate are good loans. America's future economic health depends on a more-careful reading of financial history.

Michael Milken is chairman of the Milken Institute in Santa Monica, Calif.