

**Commencement Address to:**

**BRANDEIS INTERNATIONAL BUSINESS SCHOOL**

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**GIVEN BY:**

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Good morning,

I want to talk to you about a few topics.

1. I will say a few words – this being a business school – about the idea(s) of risk – which played a large role in the financial crisis
2. I will then make a few remarks on the financial crisis itself and related policies
3. And then share my thoughts with you on some core principles which need to guide us going forward

As for my first topic, we start with a tale of two risk models, or in Charles Dickens fashion, the Bleak Houses of Lehman, AIG, Bear, et al. Bear in mind, it was the regulated institutions which needed to be bailed out or collapsed, not the hedge funds.

As long as people write financial history, there will be many proffered explanations for what caused the financial crisis of 2008. And indeed there are. They range from a breakdown in risk control models, out-of-control derivatives, ill-conceived regulations, Wall Street greed and mismanagement, to name a few. But as one of my law professors at the University of Chicago once said to me, "there is the right reason, the wrong reason, and the real reason." And the "real reason" is leverage. I know no sane individual who would lever their net worth 30 to 1, such that a 3.3% loss would wipe out their capital. And yet that is the amount of leverage with which Lehman, Bear Stearns and others operated. Every shareholder of those institutions could be said to have invested in a 30-1 levered hedge fund, of sorts. So what made the managements of these firms, and the PhDs in mathematics they hired, comfortable with such irresponsible levels of borrowings? We are led to the key suspect by Richard Bernstein's wonderful book, *Against the Gods*. It is a must read for anyone who invests capital. The answer, in short, is the 'quants.' Those who live or die by mathematical models.

There are two competing ways to understand how much risk one is taking with invested capital. The Buffet way or the 'quant' way. According to the Buffet way, risk is the possibility for permanent loss of capital. According to the 'quants' risk is a statistical portrayal of the volatility of past returns. The challenge with the first is: how does one assess the possibility of permanent capital loss? The answer is that an informed understanding of value through fundamental securities analysis, such as that provided by the respected Graham and Dodd approach, combined with investing with a 'margin of safety,' can lead one to useful conclusions. The challenge with the second, or 'quant' approach, is that one can never know for sure when one has enough data to conclude that what exhibited low volatility in the past will continue to do so in the future. A famous example of a disaster caused by the 'quant' approach was the colossal failure of Long Term Capital Management in 1998, elegantly described in the book "When Genius Failed" by Roger Lowenstein. Let's not forget that the principals of LTCM included Robert Merton and Myron Scholes who won Nobel prizes for Economic Science. Scholes, in fact, warned: "It's a wrong perception to believe that you can eliminate risk just because you can measure it." Now why is the quant model so potentially lethal? In short, by identifying past returns exhibiting minimal volatility as low risk, these 'geniuses' got comfortable with irresponsible layers of leverage. Hence the creation of all types of highly levered financial products which, in 2008, in conjunction with highly inappropriate ratings from the rating agencies, blew up, and almost took the financial system with it.

Now, this leverage game works for a while, until it stops. It is a game of musical chairs with 10 players who, when the music stops, have to compete for 1 chair, not 9. Its most recent occurrences are 1998 and 2008. It is commonly heard on Wall Street that the 100 year flood comes about once every decade. If you are materially levered when the music stops, you may get wiped out. As the saying goes, "markets can remain irrational longer than you can stay solvent."

Now a great deal of modern finance theory is good and interesting, especially many insights from behavioral finance. And certainly modern finance theory does not speak with one voice. But thinking about risk in highly quantitative terms to the exclusion of more qualitative judgments and insights is one of its core precepts. And it has had dire consequences.

As for an overreliance on statistical methods, Peter Bernstein reminded us that--markets look more efficient from the Charles River than the Hudson River.

He also told the story of the statistics professor in Moscow who continually refused to go to the bomb shelter during German air raids in World War II since, he thought, it was as likely that the Germans would bomb his apartment as they would bomb the circus and kill the big elephant. When they saw the professor a few weeks later in the bomb shelter they asked him why he changed his mind. He said that a few days ago they killed the big elephant.

The physicist, Albert Einstein, foresaw troublesome issues with a 'too statistical' view of the world when he said that 'not everything that you can count counts and not everything that counts can be counted.' Indeed.

And so, I urge you to never let the supposed wonders of the most complex models have you forsake common sense. Hubris is the enemy of capital preservation. All long-time money managers have a lot of humility. The question is: how much did it cost them before they got it?

My second topic references the expression to the effect that: "when the tide goes out you see who's swimming naked". The financial crisis, the tide that went out, demonstrated that the previous growth was largely illusory and unsustainable. We must enact policies to create real, sustainable growth in its economy.

At this time, in the U.S. and Europe, shockingly poor political leadership has seen politicians make promises in the form of future entitlements that they can not deliver on. Only strong leadership can correct this problem. In New Jersey, Governor Chris Christie vetoed a tax increase on the wealthy as 1% of New Jersey residents pay 46% of all income taxes - this is absurd and not sustainable. In fact, it is outright plunder. What got us into this crisis were rampant poor lending and borrowing standards, public and private "soft" corruption, regulatory incompetence and Congressional irresponsibility.

We are seeing instances of class warfare by politicians claiming to deliver instant jobs (just add water) combined with, in many instances, the mere appearance of growth. We must focus on thoughtful and sustainable policies, which attempt to identify and then fix what went wrong. We must carefully draft changes in law and regulation, hold accountable wrong doers and create incentives to foster the growth necessary to generate sustainable jobs. Most critical, we need to restructure the politically motivated promises made during this period of debt and wishful thinking.

Sadly, Washington tends to vilify capitalism and downplay the private sector's role as the key generator of jobs. It is using the crisis to increase federal governmental power and put more discretion in the hands of federal officials. Can you imagine going to the social security office to get your MRI or CAT scan? And it tries to raise taxes on the wealthy to the point where close to half the people pay no income tax. This course must be reversed, and it will be. It is unsustainable.

My third topic brings me to the words of Thomas Jefferson, one of our greatest Founding Fathers. His message was that loading up the nation with debt and leaving it for the following generations to pay is

morally irresponsible. Excessive debt is a means by which governments oppress the people and waste their substance. According to Jefferson, no nation has a right to contract debt for periods longer than the majority contracting it can expect to live.

*"I sincerely believe...that the principle of spending money to be paid by posterity under the name of funding is but swindling futurity on a large scale." --Thomas Jefferson to John Taylor, 1816.*

*"I am anxious about everything which may affect our credit. My wish would be, to possess it in the highest degree, but not to use it." --Thomas Jefferson to George Washington, 1788.*

*"Then I say, the earth belongs to each of these generations during its course, fully and in its own right. The second generation receives it clear of the debts and incumbrances of the first, the third of the second, and so on. For if the first could charge it with a debt, then the earth would belong to the dead and not to the living generation. Then, no generation can contract debts greater than may be paid during the course of its own existence." --Thomas Jefferson to James Madison, 1789.*

*"We believe—or we act as if we believed—that although an individual father cannot alienate the labor of his son, the aggregate body of fathers may alienate the labor of all their sons, of their posterity, in the aggregate, and oblige them to pay for all the enterprises, just or unjust, profitable or ruinous, into which our vices, our passions or our personal interest may lead us. But I trust that this proposition needs only to be looked at by an American to be seen in its true point of view, and that we shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves; and consequently within what may be deemed the period of generation, or the life of the majority." --Thomas Jefferson to John Wayles Eppes, 1813.*

What a majority of Americans fear, and what the election of Scott Brown right here in Massachusetts shows, is a deep concern with our current course. A fear that a government powerful enough to give you everything is powerful enough to take from you what it wants.

My friends, the vitality of America, this most magnificent of all nations, in spite of its imperfections, has consistently been refreshed by its immigrants--seeking freedom from oppression and an opportunity to enjoy the fruits of their own labor.

In New York harbor the torch of the statue of liberty is about freedom in all its manifestations. People did not travel here from distant shores, often risking life and limb, for an "entitlement". They come for opportunity. Entitlements (as distinct from safety nets) dilute personal responsibility for one's choices. And people taking responsibility for their choices is a precondition for a free society.

Our nation faces many challenges. Some states, through utter fiscal irresponsibility and political corruption, have rendered themselves bankrupt. Our nation is on that path. We still face religious fanatics who think flying planes into buildings and putting bombs in Times Square is a 'good thing'. And the Iranian government may soon merge religious extremism with weapons of mass destruction. And we struggle with how to deal with this pathological, death cult extremism.

To you, our next generation of leaders, we, the older generation perhaps owe you an apology--for handing you such a set of challenges. But no one said life is easy.

And so--my message to you is that you must take your education and share in the vitality of America by participating in its civic life--or in the civic life of the country to which you will one day return, and get involved to advance the common good. If you do not fight for the world you want, you cannot complain about the one you inherit.

I leave you with a quote from Ronald Reagan when he was inaugurated as Governor of California.

*“To a number of us, this is a first and hence a solemn and momentous occasion, and yet, on the broad page of state and national history, what is taking place here is almost commonplace routine. We are participating in the orderly transfer of administrative authority by the direction of the people. And this is the simple magic which makes a commonplace routine a near miracle to many of the world’s inhabitants: the continuing fact that the people, by democratic process, can delegate this power, yet retain custody of it.*

*Perhaps you and I have lived with this miracle too long to be properly appreciative. Freedom is a fragile thing and is never more than one generation away from extinction. It is not ours by inheritance; it must be fought for and defended constantly by each generation, for it comes only once to a people. Those who have known freedom and then lost it have never known it again.”*

I wish you all the best.