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The Milken Approach

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Dear Fellow Investors,

Michael Milken rose to the top of Wall Street by way of the Wharton Business School with Drexel Burnham Lambert in tow. Milken's work at Wharton was founded on the core theory that bond investors were rewarded by taking junk bond risk. Their default rate was higher than investment grade bonds, but Milken proved that investors were more than compensated for this risk by the dramatically higher interest rates that investors received. In the end, they would produce higher returns despite the higher level of corporate defaults.

I grew up a Drexel kid. My father was hired out of college by Drexel Burnham in 1980. He was with the company until 1989 when they got out of retail brokerage in the later stages of their fight with the government over the insider trading scandal that was headlined by Ivan Boesky.

In the 1990 Wesco Financial shareholder letter, Charlie Munger spoke with vitriol of Milken and Drexel (you could tell he was long Solomon Brothers). He stated:

> *The Milken Approach, supported by theories of many finance professors, argued that (1) market prices were efficient in a world where investors get paid extra for enduring volatility (wide swings in outcomes); (2) therefore, the prices at which new issues of junk bonds came to market were fair in a probabilistic sense (meaning that the high promised interest rates covered increased statistical expectancy of loss) and also provided some premium return to cover volatility exposure; and (3) therefore, if a savings and loan association (or other institution) arranged diversification, say by buying, without much examination, a large part of each new Milken issue of junk bonds, the association would work itself in the sure to-get-better-than-average-results position of a gambling house proprietor with a "house" edge. This type of theorizing has now wreaked havoc at institutions, governed by true-believers, which back their conclusions by buying Milken's bonds. Contrary to the theorizing, widely diversified purchases of such "bonds" have in most cases produced dismal results.*

Charlie couldn't have been more critical in his rebuke for what had taken place among banks and investors in that era. The widespread ownership of junk bonds is what precipitated the failure of Executive Life Insurance Company in 1990. Like Munger said, the results were dismal. This failure

wasn't due to junk bonds. Junk bonds have rewarded investors despite the default risk. However, not everyone owning them understood the risks they were taking.

Munger later said:

> *We suggest this cause: many of the foolish buyers, and their advisers, were trained by finance professors who pushed beloved models (efficient market theory and modern portfolio theory) way too far, while they ignored other models that would have warned of danger. This is a common type of "expert" error….*

These words should sit large in our minds as investors. What Munger is getting at in the "'expert' error" is what Nassim Taleb recently wrote in his book *Skin in the Game*. Taleb wrote: "To emit a Yogiberrism, in academia there is no difference between academia and the real world. In the real world there is." This is so important for partners to understand because we could make the same statement about The Milken Approach for passive investing today.

In a recent *Bloomberg*[1] article, it was announced why this provides a large advantage. "Passive investing styles have been gaining ground on actively managed funds for decades. But in August the investment industry reached one of the biggest milestones in its modern history, as assets in U.S. index-based equity mutual funds and ETFs topped those in active stock funds for the first time."

Much like the mid-to-late 1980s when a myriad of investors were pouring into the junk bond market, a wide swath of investors—irrespective of their ability—are pouring into passive index products. Like The Milken Approach, this approach is "*supported by theories of many finance professors, argued that (1) market prices were efficient in a world where investors get paid extra for enduring volatility (wide swings in outcomes)."* You get paid to be a long-term investor in stocks despite the volatility. Secondly, you are being fair in a probabilistic sense because even though certain companies you own don't have a bright future, you are guaranteed to own some portion of your capital in ones that do. Thus, market returns will cover the business losses. Lastly, let's apply Munger's insight, "say by buying, without much examination" a certain portion of the passive indices in recent IPOs of companies that have come to the markets with high stock market capitalizations.

History will argue you would receive "sure to-get-better-than-average-results position of a gambling house proprietor with a 'house' edge." The house edge is the size of the business compared to the overall market. Many writers have talked about the narrowness and skew of the stocks producing the market returns. We believe that "widely diversified purchases of such" stocks via these index fund products are likely to produce dismal results.

The irony to today's overconfidence in the "'expert' error" with passive index products is that Warren Buffett, Munger's friend and business partner, has blessed the practice on multiple occasions. However, heed the caution Munger gave in 1990 for the problems of today. We believe that the buyers of the passive index products are very unaware of the risks they are taking over the next ten years.

So let's use Munger's advice of 1990 for today's common stock owners, "We suggest this cause: many of the foolish buyers, and their advisers, were trained by finance professors who pushed beloved models (efficient market theory and modern portfolio theory) way too far, while they ignored other models" like

valuation and the discounting mechanism of interest rates that warn them of danger. Beware of this "common type of 'expert' error" in today's expression of The Milken Approach.

Warm regards,

Cole Smead, CFA

[1] https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift

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