Crash!

With the stock market making new highs, some pundits are sounding the alarm that a stock market crash is at hand. While it is virtually impossible to accurately predict the exact moment the next crash will occur, it is helpful to understand the origins and causes of prior market crashes and draw lessons from those events.

What investor wouldn't want to avoid the next big decline? If one had invested $1 in the Dow Jones Industrial Average on December 31, 1899, it would have grown to $156.88 by the day of the last stock market crash. But if that investor could have just avoided the single worst day in stock market history (October 19, 1987) that dollar would have grown instead to $202.71. And if that investor would have been prescient enough to avoid the five worst days, his dollar would in that case be worth $319.24. That's more than double what it otherwise would have been!

Luckily for us, CNBC contributor Scott Nations' recently-released book helps us in this endeavor to learn the lessons of prior stock market declines. In *A History of the United States in Five Crashes*, Nations recounts what led to the crashes of 1907, 1929, 1987, 2008, and 2010. The book is a pleasure to read, not only because the stories are fascinating, but also because the author makes interesting connections between seemingly unrelated events and the crashes themselves.

The Panic of 1907

In 1907, the recently created trust companies were all the rage. Trust companies were entities that originally administered trusts and wills, only to later evolve into accepting deposits and making loans. Unlike banks, trust companies had no reserve requirements, so they had a cost advantage that many exploited, creating a highly leveraged situation that proved to be catastrophic.

When the economy entered a recession, there were numerous runs on these trust companies, creating a panic that spread like wildfire. The panic subsided only when financier J. P. Morgan pledged large amounts of his own money and convinced New York bankers to commit $27 million to shore up the banking system.

For the month of October, when the panic really took hold, the Dow lost 14.8 percent of its value. During that month the market closed lower on 19 of the 27 trading days. When the stock market closed on the last day of 1907, the Dow had lost a full 37.7 percent for the year, its worst-ever annual performance until the Great Depression, and still the second-worst of all time.

The Panic of 1907 led to the Federal Reserve Act of 1913, which created the Federal Reserve System. The Fed controls the central banking system of the United States by setting monetary policy. It aims to do this with three objectives in mind: maximizing employment, stabilizing prices, and moderating long-term interest rates.

The Crash of 1929

During the Roaring Twenties, the stock market boomed. It was a decade of wealth and excess, culminating with a combined 90.8 percent gain for the Dow in 1927 and 1928. The excess of the day was exemplified by the creation of investment trusts, which were entities whose sole purpose was to hold stock in other companies. These were the precursors to the modern-day mutual funds. In their euphoria, investors drove investment trust valuations to levels much higher than the value of the individual securities in the portfolio.

The market finally broke and, on October 28, 1929, the Dow lost 12.8 percent. The next day the Dow suffered a further loss of 11.7 percent. These were the two worst days the market had ever experienced to that day.

The Crash of 1929 led to the Securities Act of 1933, which regulated the offer and sale of securities, and to the Securities Exchange Act of 1934, which created the Securities Exchange Commission, the regulatory body for the securities industry.

Black Monday

In 1979 two academics, Hayne Leland and Mark Rubinstein, developed a series of rules that supposedly ensured that the value of a stock portfolio would not fall under a specific value, regardless of the drop in the broad stock market. Their product, at first called “dynamic hedging” but later more widely known as “portfolio insurance,” utilized a rigorously mathematical trading system involving stock options such as puts.

Their product did not immediately gain wide acceptance, but it caught on about a decade later. At when it caught on, it caused the greatest single-day drop in U.S. stock market history. The problem with portfolio insurance was the mistaken belief that, as stated by Nations, “their own regimented trading would not affect the price of the underlying stock even if the volume of their selling increased.”

On Monday, October 19, 1987 a falling market prompted portfolio insurance trading to spring into action. This triggered even more selling, soon creating a vicious cycle. That day the market experienced its worst one-day drop in history, with the Dow falling exactly 508 points or 22.6 percent.

The Mortgage Meltdown

Fueled by easy money from financial institutions and from the fervent belief that housing prices could only go up, people of all stripes bought houses in the early- to mid-2000s not to live in, but to “flip” them for a quick profit. Ever-rising home prices prompted even more greed, as Wall Street bankers facilitated the demand for more easy money with their introduction of asset backed securities.

We can all still vividly remember how it ended in 2008. Home prices collapsed nationally, prompting foreclosures, bank failures and a stock market crash. There was never a single day in 2008 when the stock market closed at a higher level than where it ended 2007. June and October showed losses of more than 10 percent each. When the bottom was finally reached on March 9, 2009, the Dow had declined by a stunning 53.8% from its high in 2007.

The Flash Crash

On May 6, 2010, stock-trading robots, also known as "algorithmic trading", caused a stock market crash that lasted just over half an hour. The prices of many stocks collapsed in a matter of minutes, with no apparent reason, just to quickly bounce back in a matter of minutes. The stock of blue-chip Procter & Gamble (PG) dropped 37% in less than four minutes, wiping out $63 billion of market value. Another solid company, consulting giant Accenture (ACN) had an even steeper drop. From 2:30 p.m. to 2:47 p.m., the stock dropped from $41 per share to a laughable $0.01.

At the low point of the day, the Dow had lost over 1,000 points, dropping 9.2 percent. By 2:52 p.m., though, the market started to recover. At the end of the day the Dow had closed down just 3.2 percent, after gaining back more than 650 points.

Lessons

One of the most interesting aspects of the book are the similarities that the author finds between all the crashes. The first is that all modern stock market crashes are preceded by two-year periods of euphoric buying inside a decade of healthy returns. Then, some external catalyst—geopolitical, political, or even an act of nature—jumpstarts the decline.

The most interesting commonality between the crashes is that every crash was fueled by a new "financial contraption" that was poorly understood at the time. In 1907 it was the trust companies and in 1929 in the investment trust. In more recent times, it was products that were supposedly meant to reduce risk—portfolio insurance in 1987; mortgage-backed securities, credit default swaps, and collateralized debt obligations in 2008; and algorithmic trading in 2010.

Conclusion

A History of the United States in Five Crashes is a worthwhile read for any student of stock market history. In the current time of low volatility and complacency in the stock market, investors—both novice and experienced—will be well served to revisit those moments in history when fear was the rule of the day.

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