Financial Tailor

December 16th, 2013

The Rise and Fall of Jay Cooke & Co.

Author: Benjamin Struck
President

Last week the markets suffered their biggest weekly decline since August. Late day selling sparked much of this selloff, which is interesting because late day buying had been the norm for quite sometime. Next week the FOMC (Federal Open Market Committee) will meet to discuss whether the Fed should reduce its monthly bond purchases. I will be surprised if the Fed decides to begin tapering since inflation remains well below fed targets. Instead of reviewing current events or pontificating on the possibility of a fed taper, I am going to go back in time and tell the story of the long depression.

I recently acquired an old atlas of Indiana from 1876. In the preface to the atlas, the publisher made note of the difficult times that they faced and how the depression had impacted their subscriber list. I think it is interesting that most people are familiar with the great depression of the 1930's, but are completely unaware of the Long Depression.

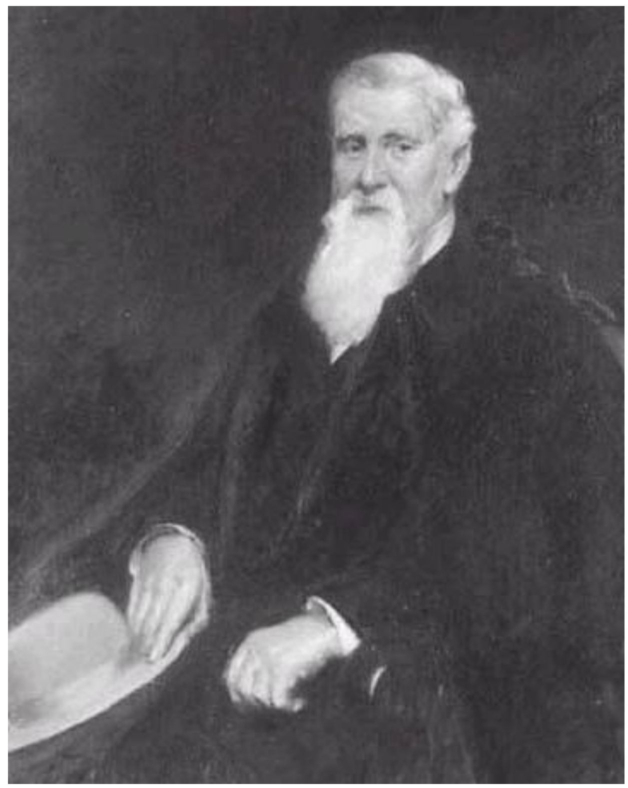
The Long Depression lasted from 1873-1879 making it the longest economic contraction in history, even longer than the Great Depression. In fact, the Long Depression was known as the Great Depression prior to the 1930s. The Long Depression took place after the reconstruction period that followed the Civil War. To better understand the Long Depression, it helps to examine the company at the center of the problem.

Jay Cooke & Company

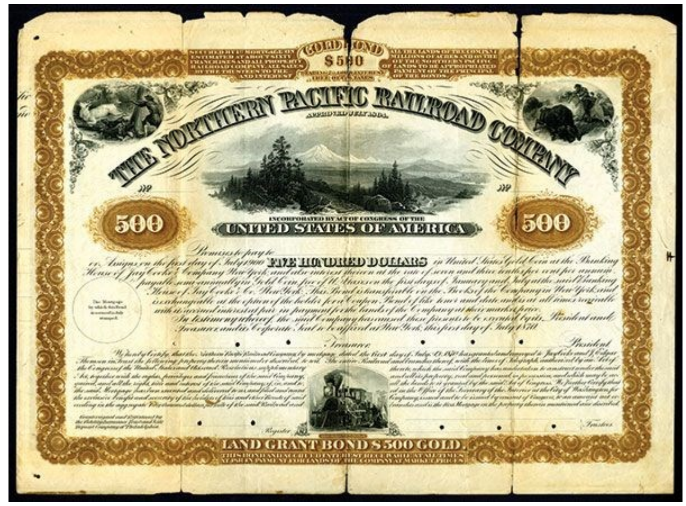
Jay Cooke & Company was a bank founded during the Civil War. Congress attempted to sell $500 Million in bonds to finance its war efforts, but failed to do so. The Treasury reached out to Jay Cooke for help selling the bonds. Cooke used a number of financial innovations to sell the bonds. He used a network of real estate agents, insurance salesman and bankers from around the Union to sell the bonds. He was also the first to use the telegraph to record sales through a centralized location. Jay Cooke was able to sell all of the bonds and in the process he revolutionized the financial industry. Cooke had taken a huge risk in selling these bonds. The Union assumed no risk selling the bonds, and provided no compensation unless he was successful. Had he been unsuccessful the administrative costs alone would have ruined Cooke. "He had an agent in every village, and a standing advertisement in every newspaper, and the expense was enormous", according to

Weekly Changes

S&P 500 Index		
-32.47	**-1.80%**	
Dow Jones Industrial Average		
-270.68	**-1.69%**	
NASDAQ Composite		
-71.24	**-1.75%**	



reports[1]. Cooke racked up over $500,000 in expenses before making a return, but through his vast network he was able to sell the entire issue, and more. Cooke's gamble had paid off, but his luck wouldn't last forever.



The Railroads

After the war, the United States began rapidly expanding railroads with the goal of creating a trans-continental railroad. The government provided land grants to railroads who were willing to meet certain objectives.

The Northern Pacific Railway Company was chartered by congress to connect Washington and Oregon to the Great Lakes. In the beginning, the Northern Pacific had difficulty finding financing. Once again, Jay Cooke came to the rescue. After Cooke, announced that Cooke & company was backing the Northern Pacific it was able to gain momentum. Pulling from a similar playbook as last time, Cooke used his vast sales network to market and sell the bonds to finance the Northern Pacific.

Cooke & Company began issuing its own bonds backed by its ability to sell the bonds of the Pacific Northern. This leverage would have allowed Cooke to make an enormous profit if he were successful in selling the bonds. Cooke expanded his sales network and began selling the bonds in Europe as well. Despite his best efforts Cooke had difficulty selling as many bonds as he expected. Eventually rumors began to circulate about his creditworthiness, and like most rumors of bank insolvency, perception quickly became a self-fulfilling prophecy via a liquidity crisis.

The Panic

An anonymous journalist remembers the failure, "Shortly After twelve, the presiding officer arose, holding aloft a small slip of paper, and, bringing down his gavel with a vehement jerk, made this announcement: "THE FIRM OF JAY COOKE & CO. HAVE SUSPENDED!"[1]

The Failure of Jay Cooke & Company set off a wave of defaults throughout the financial industry, and stocks plummeted as panic ensued. This is generally considered the beginning of the global financial crisis known as the Long Depression. Next week, we will look at the aftermath of this crisis.

[1] *History of the Terrible Financial Panic of 1873*, Anonymous

Strategic Allocation

Conserva- Aggressive

RISK SCORE	1	2	3	4	5	6	7	8	9	10
Debt	66	54	48	40	33	27	19	15	8	8
Short Term	28	21	19	16	14	10	7	5	3	3
intermediate term	20	21	20	15	13	11	7	5	3	3
long term	9	7	7	7	4	4	4	4	2	2
floating	9	5	2	2	2	2	1	1	0	0
Equities	18	27	33	41	47	51	59	64	71	71
small cap	3	4	8	8	13	14	17	21	27	32
mid cap	3	5	9	14	14	17	23	24	26	28
large cap	12	18	16	19	20	20	19	19	18	11
Other	16	19	19	19	20	22	22	21	21	21
Reits	8	10	10	10	10	11	11	10	9	8
Commodities	5	6	6	6	7	8	8	8	9	10
currency	3	3	3	3	3	3	3	3	3	3
total	100	100	100	100	100	100	100	100	100	100

The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

Overweight short term debt, particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

Neutral intermediate term debt

Neutral Long Term Debt, Long term debt has substantial risk if interest rates rise, but can still help alleviate losses in the event of a rapid stock market selloff. This asset class has been oversold and we are using closed-end funds that are trading at a discount to net asset value to participate.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

Neutral Small Capitalization Stocks, we are very cautious in this area, but still believe that carefully selected value stocks can continue to outperform.

Neutral Mid-Cap Stocks, we apply the same logic to this asset class as to small cap stocks.

Neutral Large Cap Stocks, We are more selective with large cap stocks, if signs of inflation pick up we will look to invest in large cap companies with high debt. We are extremely bearish on tech companies with stretched earnings multiples.

Neutral REITs,

Underweight Commodities,

Currency - We are underweight the Euro. We are very negative on the yen, and expect a dramatic decline within the next few years. We are currently holding higher levels of cash generally.