# The Plunge Protection Team
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# Randomness and Responsibility

**By John Mauldin**

I have had so many letters of late asking me what I think of and/or know about the existent of the so-called Plunge Protection Team, that mysterious group of government officials who secretly prop up the stock market when it drops too much, that I am going to jump in where wiser minds would just leave the subject alone. It will offer a good opportunity for you to understand concepts of arbitrage and how the markets really work. Plus, if you can prove me wrong, I will show you how to get a quick $100,000.

Following the stock market crash in 1987, the government created something called the President's Working Group on Financial Markets. The group, which includes the Treasury secretary, Federal Reserve chairman, chairman of the Securities and Exchange Commission and chairman of the Commodity Futures Trading Commission, was formed to ensure the smooth operation of financial markets.

Citing a Washington Post article, Carol Baum recently wrote about a 1997 article: "The Working Group's main goal, officials say, would be to keep the markets operating in the event of a sudden, stomach-churning plunge in stock prices -- and to prevent a panicky run on banks, brokerage firms and mutual funds…"

"The thrust of the article is official's efforts to avert a liquidity crisis, which is exactly what the Fed did when it flooded the banking system with reserves following the 508-point plunge in the Dow Jones Industrial Average on Oct. 19, 1987. How an effort to ensure adequate access to credit to prevent a domino effect in the event of market meltdown morphed into a cabal to prop up the stock market is anybody's guess. For a window into the depths of the conspiracy theory, type "plunge protection team" into Google and see what comes up."

Every time the market drops and then "mysteriously" rallies, knowing individuals look at each other and nod, seeing the handiwork of the PPT (plunge protection team).

Let's say it straight out. The plunge protection team does not exist. It is an urban myth. Let me step by step prove it does not exist, and see if we can learn something in the process.

Supposedly the PPT manipulates the market by buying S&P 500 and DOW and NASDAQ futures when the market is dropping. Somehow, this supposedly forces the market back up. The problem is that buying futures cannot drive the stock market, which is obvious to real traders.

I talked with a few good friends about this article prior to writing it, to get some background and ideas. Art Cashin, of CNBC fame, and one of the real veterans of the markets, who ahs seen it all, wrote me the following very clear thoughts:

"Suppose you have a lot of cash and would like to buy the S&P Index. In the old days (circa 1980), you had two choices. You could buy each of the stocks in the S&P according to its weighting. Then you would own a "basket" of the 500 stocks. Or you could buy an S&P futures contract on the S&P. Which should you choose?

"If you bought the 'basket' of stocks, you would get whatever aggregate price improvement (or loss) that occurred while you owned the basket. In addition, you would get any dividends paid. A slight negative would be that it required 500 transactions (1 for each stock) and thus 500 commissions.

"If you bought the "futures," it would give you similar price action since it would mirror the ups and downs of the basket and the index. A negative would be that you would not get the dividends. Positives would be a single transaction with more favorable margin requirements.

"By constructing a formula of the variables - total dividends, time left to expiration and interest rates, etc. - you can determine if one of these choices is cheaper than the other. This is called arbitrage.

"An old example of arbitrage was gold. If gold was selling at $300 in Paris and $350 in London, one Rothschild might send in a pigeon to another Rothschild suggesting A buy in Paris while B sold in London allowing the firm to pocket the $50 (less transportation and currency conversion).

"The futures/basket formula gives you equilibrium or Fair Value. If stocks (the basket) go up faster than the futures, you might sell the expensive stocks and buy the cheaper futures. If the futures ran faster then you would, do the opposite. This is called index arbitrage or sometimes program trading….

"Anyway, the arbitrage between baskets and futures is now much bigger thanks to the addition of Exchange Traded Funds (ETF's). So now you can "arb" the basket against the futures or the S&P Index (ETF) (or any combo thereof). It is a huge market."

* Trading desks do arbitrage program trading for a fraction of a percent on a trade. Any attempt by the Fed to manipulate the market would just make a lot of money for hedge funds and trading desks.

* The amounts of money required to attempt such a manipulation would be huge. We are talking tens of billions of dollars if there was a true collapse going on. The collective size of the trading community in the world (hedge funds and "prop" desks – a prop desk is a proprietary desk for an investment bank or broker-dealer) is in the multiple

hundreds of billions. It would require the willingness to lose billions of dollars every time you took the plunge, so to speak.

* If the Fed or Treasury or some slush fund did buy stocks, it would inject liquidity or more total money into the financial system or money supply. Since the Fed openly manipulates the money supply every day in transactions that everyone can see, in order for the Fed to hide the activity of the PPT, they would have to take out liquidity by selling treasury notes. Otherwise, the numbers at the end of the day or week would not add up, and someone would notice. But if they were taking out liquidity and the money supply did not go down, then someone would know something was up. You can't hide these numbers, unless you can get a lot of clerks at the Fed and elsewhere to agree to lie.

* You could not keep something of this size secret. Period. The orders would have to be entered somewhere. The theory is that Goldman Sachs or Citibank (or pick a firm) is part of this conspiracy. That means that multiple traders and officers would have to be in the know. You cannot mask trades of that size because it would essentially be the largest hedge fund in the world. Someone would spill the beans. Can you imagine the signing bonus from a book publisher if you could prove the existence of the PPT?

I hereby offer a $100,000 advance against 50% of the royalties to anyone who can "show me the trades." Give me names and dates. I will write the book, and we both become famous.

Further, can you imagine what political hay the opposition political party would make of the proven existence of a PPT? Do you think that the Dems wouldn't love to embarrass Bush with "proof" of his manipulation of the market? Can you imagine Newt Gingrich or Tom DeLay (Republicans) not beating up Clinton and Robert Rubin for crimes against the market and for losing billions of dollars of tax-payer money?

If the President's Working Group was really the PPT, do you think every former SEC and CFTC Commissioner (and there are maybe a dozen) would all keep silent after they are out? Do you think their wives (or husbands) would not tell all in a divorce hearing? Do you really think that if Harvey Pitt would have allowed George W. to fire him if he could blow the whistle?

## A Hedge Fund's Secret Wish

* I don't doubt there are all sorts of secrets that officials in our government keep from us, and that all sorts of untoward things are done every day in the government, that if we found out we would be shocked.

But if the PPT existed, it would be just too big to keep secret. If it were small enough to be secret, it could have no effect upon the market. I don't doubt for a second that if the Fed decided to buy stocks and was willing to risk losing hundreds of billions, they could move the stock market up for a period of time. But then what do they do? They own a bunch of stocks. Could they ever sell without causing a crash?

Furthermore, if there is a PPT, they are the most incompetent team in the world because the markets have indeed plunged. I can guarantee you this: it is every hedge fund's most fervent wish that there was a plunge protection team, because it would be a license to print money trading against them. Imagine, having someone on the market with an unlimited bank account whose objective was to lose money? Could it get any better?

Some would argue that the PPT does not lose money - that they are so good they buy the stocks and wait until the market goes back up before they sell. If there were individuals who had such god-like insight into the future direction of the market, they would be running their own funds, making tens of millions in annual fees, far more than they would make as a bureaucrat. Further, as the bear market has moved the market down, the losses would be in the hundreds of billions by now. That much loss cannot be hidden, even if you have a printing press.

* If you believe in the PPT, it probably would do no good to mention that the rules under which the Fed operates makes it illegal for them to participate in such an operation, since you would assume they would not follow their own rules.

Let's look at the Crash of 1987. At the end of the day, there was a huge amount of futures buying, which some say is evidence of the Fed or other group stepping in and stopping the bleeding. What really happened is that the futures got so out of whack with the physicals that it was an obvious arbitrage position, and Paul Tudor Jones, one of the largest and certainly one of the more highly respected traders stepped in and began to cover his huge short position. Jones was a legend. Once the word hit he was covering, the crowd stormed in. No conspiracy. No hidden machinations. Just some traders taking monster profits.

And that often is what you see when there are large and strange moves. Just traders taking profit, either on the long side or short side.  It is what Chris Fuligni calls his TFTF trade: Too Far Too Fast. When the market moves too much in one direction, traders take profits.

In my opinion, and as I have made the case for several years, this market is too high compared to historical trends of value. In my opinion, it has much further to go on the downside. But secular bear markets do not go straight down to "fair value." It takes years of going down, with large rallies back up and then more down before the bottom is finally reached. At every step, there are advisors and investors who decide that "now" is a good time to invest. There is no mass consensus.

Remember, over half the years within a secular bear market cycle are up years, and most of those are up by 20% or more. As the fairly bearish Dan Denning wrote in Strategic Investment today: "…confidence can be a heady thing. If Hussein ends up dead and Osama bin Laden is captured, look for 10,000 on the Dow in short order. Euphoria is a powerful emotion."

Those who feel the market is over-valued have ample justifications. You can go to Standard and Poor's website and look at their valuations. If you take pro forma earnings (that is Earnings Before Interest and Hype) the current P/E ratio is 18, which is high, but certainly within historical norms. But if you look at actual "as reported" earnings, the P/E ratio jumps to 30.29. That is in nose-bleed territory to the historical average of 15.

If you look at core earnings, the number is over 35. Core earnings subtract options expense and pension fund overstatements. The new accounting standards will probably mandate firms to start subtracting these items, so the core earnings P/E ratio is a number that is increasingly going to be seen by the investor.

Not fair, say the bulls. To get true historical comparisons, you have to compare apples to apples. The new standards distort the actual profitability of a company, and give us no fair historical comparison.

To that, I politely say bunk. Pre-1990, pension benefits did not have nearly the impact that it does today, as there was not that much over-funding and estimates of future earnings were far more conservative. It is only in the decade of financial engineering, where a CEO could create a 10% rise in his company earnings just by changing the assumptions of his company pension fund that these elusive pension fund earnings started to show up in the books in a significant way.

Of course, that helped the CEO's personal options, which again the company did not have to expense. Options were not a big deal prior to 1980 and not all that significant even until 1990.

Accounting standards always tighten up in bear markets. Investors become more conservative. They are not willing to project earnings growth far into the future. That is why the market drops.

If you go to Decisionpoint.com, you can see in one of the many hundreds of charts available that if the P/E ratio for the S&P 500 were 15, about average for the last century, the market would be at 420 today. As markets have always over-corrected, generally to below single digit P/E ratios, if it went to 10, the S&P 500 would be at 280, down 68% from here. That is pretty ugly.

I believe we are going to single digit ratios. I also believe it will take a decade or more. In that time, earnings will grow, and probably double or more without having to be too optimistic. What happens in secular bears is that earnings grow and P/E ratios drop. But it does not happen all at once. It takes time.

We can be thankful for that, because if the markets were to drop 68% today, we would be facing a depression as severe as our grandparents faced. It would be ugly, ugly, ugly. Thus, in a kind of perverted logic, we should be grateful for market cheerleaders, as they prop up the economy and stave off a disaster scenario. But as individuals, we don't have to listen to them.

The point is that there are those who see the market as under-valued. When it does not go up they blame hedge funds, short sellers and wicked analysts for their losses. There are those who see the market as over-priced and want the market to conform to their worldview, and they see rallies as evidence of the Plunge Protection Team. The world is not as it should be, and there must be some secret reason. That is especially true if they are short and the market goes up.

The real reason is what Richard Russell says over and over, “The market is the market. It just is.” In a real sense, this is more scary than the possible existence of a plunge protection team. It means we are subject to the vagaries of a market which is out of anyone’s ability to control. I bet there have been a few times you wish someone could have made the market go back up. In a world where anything can happen, risk control is everything. It would be nice to know that I could count on some secret group to protect my funds, but it doesn’t exist. I am responsible for my own risk protection and personal portfolio.

## Randomness and Responsibility

Thus, we return to Art Cashin’s final bit of wisdom: “People can't stand two things - randomness and responsibility. On the first point we again cite Voltaire: “If God did not exist, it would be necessary to invent him.” The premise is obvious and a truism - life must have order. The class needs rules and a teacher. An occasional accident is acceptable, though maybe not understandable. The logical (for many of us) existence of a deity transmutes in the secular world into - someone is in charge. (The government, the moneyed interests, some religious or ethnic group, etc.)

“Now factor in the inability to accept responsibility.

“If my horse doesn't win - the race was fixed - the horse was doped. The variations are myriad. It can never be my fault or my miscalculation. That could mean I was careless, or confused or hasty or maybe even wrong. The latter is unacceptable so it must be someone else.

“Thus conspiracy theorists and the plunge protection theme. In four decades, I've heard hundreds of theories. The collapse of the Hunt Brothers' silver bubble was roundly blamed on a government conspiracy. As time went on it was obvious there was no conspiracy - not there or in hundreds of other cases. But....when your perfect game is ruined in the final frame (bowling) or the final inning (baseball) - dashed hopes demand a villain - an evil deus ex machina. They stole it from me, I tell ya!!”

## Time Out

It is late on a Friday evening. I have had more distractions on my Friday e-letter writing afternoon than any time in recent memory. There are a dozen other topics that deserve mentioning. Steve Roach of Morgan Stanley now predicts the world will slide into a double dip recession as the SARs virus hits the world economy. Housing remains strong, yet the IMF warns of a bubble in housing. Dennis Gartman reports shipping rates and shipping is up, which means world trade may be improving. Unemployment is up, manufacturing is down, and the service industry is in contraction mode.

In short, it does not look good for my Muddle Through scenario. While I clearly think we will have another recession, at the beginning of the year, I thought we could avoid it for 2003. Now, I seriously have questions about that prediction. And yet, the economy will probably have grown a little more than 1% in this last quarter, and it looks to do so in the second quarter. Could an end to the war create that euphoria Denning mentioned. Stay tuned, as I will just have to address this next week.

Speaking of conspiracies, my Dallas Mavericks lost to the Lakers last night. I was right down front, and I can tell you that there was clearly a conspiracy among the referees to allow Shaq to get away with anything. You could see them looking at each other. I saw all sorts of winks and hand signals. We were robbed.

Your ready for the weekend analyst,

John Mauldin