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Critical Review - Panic

Panic: The Story of Modern Financial Insanity is a non-fiction book edited by Michael Lewis about the most important and severe upheavals in past financial history. **My thesis: The underlying causality of immoral behavior stems from market volatility itself**

Free Financial Markets - An Angelic Figure with a Devilish Nature

Supply and Demand, two sides of the same coin, and the dominant factors that establish price discovery in free markets. Although the U.S. stock market and broader economic structure are not completely free, for this paper, the term “free market” will refer to them as such. Free markets are characterized by volatility, peaks and troughs, where market participants attempt to gain an upper hand by any number of analytical or qualitative approaches. Within this volatility, improbable or seemingly impossible events have occurred, inspiring financial crises that send shockwaves reaching much further than Wall Street. *Panic* by Michael Lewis insightfully profiles four of these major market crashes: the 1987 United States stock market crash, the 1997-98 emerging-market failure, the dot-com bubble of the early 2000s, and the infamous 2007 - 2008 global financial crisis. Lewis, a passionate writer and ex-bond trader, defines the purpose of panic as “to recreate the more recent financial panics, in an attempt to show how financial markets now operate” (Lewis 11).

Unconventionally, Lewis utilizes a wide variety of media to provide perspective and establish context around each of these panics. In each section, he provides an opening with his perspective or experience for each panic, followed by a collection of literature (tending to be chronological) encapsulating the “feeling in the air immediately before things went wrong” and followed by “many attempts to come to grips with the strange and unexpected seeming disaster that just occurred” (Lewis 11). However, Lewis does not constrain himself to financial books and has written two New York Times best-selling books, Moneyball and Blindside, which tell stories of unlikely winners in sports realms. In each of these books he tells stories and derives

arguments by supplementing analytical findings with psychology and game theory. This emphasizes the idea that Lewis is not a one-trick pony, not confined to financial analysis for the reasoning behind these panics, but rather, *Panic* contains a deeper analysis of the catastrophes, root causes, and underlying themes. Lewis, through his time on Wall Street and beyond, has experienced each of these crashes with differing personal implications or incentives; however, Lewis provides a bipartite framework for the overarching catalysts of these panics: inadequate comprehension of market factors, and deficiencies in human perspective. Dissent with these conclusions is futile, of course, a deficiency in understanding markets coupled with human bias is a recipe for disaster. However, Lewis skirts the fundamental issue and uses these characteristics to subvert the underlying truth that emergent properties of free financial markets incentivize incurable characteristics of human behavior. Free markets may be the best way to allocate resources, but they have become glamorized and incentivize knowingly or unknowingly immoral actions.

With financial equations, models, or theories, the operating assumptions must be analyzed and understood to effectively determine the utility of the product, and the same applies to this paper. With this, *Panic* is analogous to the content of the equation and Michael Lewis's perspective is the operating assumptions. Therefore, to accurately analyze the arguments presented in *Panic*, characteristics of Lewis's perspective must determined. Once characteristics have been made, they will function as assumptions to supplement arguments, establishing context for why Lewis approaches and profiles situations in any certain manner.

The vast majority of Americans would be envious of the hand Lewis was dealt to begin his life. Lewis's family lineage has some of the most notable figures in American history being a

"direct descendant of the famed explorer Capt. Meriwether Lewis on his father's side and of U.S. Pres. James Monroe on his mother's" (Volle 2024). His father was an extremely successful corporate lawyer, enabling him to be educated at the prestigious Isidore Newman School in New Orleans. Lewis's privileged upbringing likely shielded him from the disruptive financial forces that impact the lives of so many. Although the impact of wealth on childhood development is uncertain, the evidence overwhelmingly points to wealth as the "strongest determinant of class status. It increases power, independence, and social and cultural capital, which provide positive personal and social effects on family and child well-being beyond those conferred by income alone" (Miller 2021). Additionally, wealth leads to a greater sense of financial stability which gives less concern for budgeting and more room for exploration. This aligns with Lewis's actions, after attending Princeton and receiving a degree in Art History, he bounced around for two years, taking up jobs as a "stock boy for an art dealer in New York, cabinetmaker's apprentice in New Jersey, and European tour guide" (Volle 2024). Studying Art History and taking professions considered to be well below that of an Ivy League-educated student further points to the idea that monetary success is not a driving motivator in Lewis's actions. Additionally, his affinity for satire in financial journalism is circumstantial proof of his monetary indifference, but directionally supportive. After two years, Lewis would go back to school to obtain a master's degree in economics from the London School of Economics and Political Science. Volle details that during his time pursuing a master's degree, Lewis's cousin, "invited him to a dinner party she had helped organize for Queen Elizabeth II and sat him next to the wife of a managing director at Salomon Brothers." After being impressed, the woman urged her husband to give Lewis an interview, and this ended with him being hired as a junior bond

salesman for the prestigious investment bank. Lewis leveraged his connections to obtain a position coveted by so many, and regardless of whether it was "deserving" or not, it is improbable Lewis would have obtained this opportunity in the absence of his family's assistance. Both wealth and nepotism are commonly known to foster characteristics such as entitlement and narcissism. Lewis clearly possesses a stellar work ethic and intelligence, evidenced by his numerous best-selling books and industry reputation, but this does not negate the possibility of narcissism. To go into these characteristics further, in his most recent book, *Going Infinite: The Rise and Fall of a New Tycoon,* Lewis profiles the rise and fall of Sam Bankman-Fried (SBF). SBF was the founder of FTX cryptocurrency exchange. During his time at FTX Sam was celebrated as a leader in the crypto industry and a virtuous person through actions such as charitable donations and a commitment to veganism. However, there was a much darker side to the story, SBF was found guilty of "two counts of wire fraud, two counts of wire fraud conspiracy, and three other conspiracy charges" (Rosenberg 2024). Additionally, he was charged with stealing at least 10 billion dollars from customers and investors, making him one of the biggest scam artists in history. Michael Lewis had unparalleled access to SBF, residing with him in the Bahamans for months and reportedly seeing SBF more than the founder saw his own parents. On the same day SBF's criminal trial commenced, Lewis released his book. *Going Infinite* and portrayed SBF as "incredibly naive and someone who simply didn't pay enough attention to critical operational details" (Svensson 2023). Lewis paints a picture of SBF as misunderstood, rather than outright fraudulent. This perspective merited high amounts of controversy from the press and the broader public. Simply put, how can a Massachusetts Institute of Technology and Jane Street Capital alum start an exchange worth 32 billion at its peak, but

also be incredibly naive and miss critical operation details, like fraudulent financial statements and gross misuse of funds? After the trial, Lewis was confronted about his controversial opinion of SBF, Lewis responded with “This is what happens when you address a mob” (Chow 2023). This shift of blame and inability to admit fault points to deeper-rooted narcissistic tendencies Lewis embodies.

Soloman Brothers was just the beginning and Lewis’s start on Wall Street and spurred his success in the writing world as well. He eventually left Soloman Brothers in 1988 to pursue full-time writing, becoming one of the most coveted financial journalists in recent memory. Lewis is an extremely complex person, with a degree in Art History, a privileged upbringing, and professional experience as a cabinetmaker’s apprentice, two assumptions can be made about Lewis’s perspective: Lewis’s motive for action is likely not monetary, and Lewis, if not a moderate narcissist, has narcissistic tendencies. Lewis’s indifference to monetary accumulation is extremely significant when interpreting *Panic*. When describing the fallout from financial crises, these are likely to have had less of a financial impact on Lewis in relation to the average market participant. This likely allows Lewis to be more objective and satirical in his commentary. Lewis’s narcissistic tendencies may lead him to have difficulty accepting blame for consequences or distort his perspective on the validity of external arguments.

Firstly, Lewis profiles inadequate comprehension of market factors as a driver of financial panics. Inadequate comprehension of market factors is best elucidated by the famous Black-Scholes Model. Lewis describes the Black-Scholes model as the “most influential idea on Wall Street” (Lewis 4) and the 1997 Nobel Prize in Economics was awarded to its living creators, Robert Merton and Myron Scholes. The mathematical model was used to price options

and made the basis for a new strategy called portfolio insurance. Portfolio insurance asserts that a "trader can suck all the risk out of the market by taking a short position and increasing their position as the market falls" (Lewis 4). As history proved, this assumption was incorrect, and portfolio insurance was a significant factor in the 1987 stock market crash.

The idea that a market trader can completely avoid market risk is simply ludicrous; however, this assumption was widely adopted and even praised among the most sophisticated Wall Street investors. Lewis attributes this to the complexity of the model and states, "If you try to attack it, says a longtime trader of abstruse financial options, you're making a case for your own unintelligence. The math was too advanced, the theorists too smart; the debate, for anyone without a degree in mathematics, was bound to end badly" (Lewis 5). Lewis designates the problem with the Black-Scholes Model to its complexity, however, the complexity is only relevant because of deeper human characteristics. The reason portfolio insurance was devasting for the U.S. stock market in 1987 was rooted in investors' craving to feel intelligent. When introducing extreme amounts of complexity into the market, such as portfolio insurance, investors use it because of what it sounds like, rather than what it is. This is clear because the investor does not even know what it is (unless they have a degree in mathematics). Rather than the inherent complexity of the model itself that presents an issue, it is the necessity for people to feel intelligent that breeds issues. Extensive bodies of scientific research point to people participating in activities or sharing opinions they don't understand to seem more intelligent, and this situation is no different.

The Black-Scholes model is far from the only example of this occurrence. During the dot com boom of the 1990s, "a 15-month old company that has never made a dime of profit had one

of the most stunning debuts in Wall Street history yesterday as investors rushed to pour their money" (Lewis 165). The company, Netscape Communications Corporation "reported a six-month loss of 4.31 million, and analysts said the company as unlikely to show a profit for at least two years" (Lewis 164). However, this did not stop investors from pouring their money into the latest and greatest technology. Another example of this is Healtheon, the internet healthcare startup. When Healtheon's chief technology officer, Pavan, spoke to investment bankers on Wall Street concerning the prospect of investing in Healtheon. Lewis describes his pitch as "abstraction followed abstraction in the manner of contemporary art criticism" (Lewis 181). The bankers at Morgan Stanley were outclassed to the maximum, unable to comprehend the grand and bold answer given by Pavan. Following the presentation one of the bankers has the wit to ask Pavan "Is there any major piece of the platform that has not been built?", to which Pavan replies, "not really" (Lewis 181). Even with this inconclusive answer, not a single banker challenged Healtheon any further. Lewis subtly attributes Pavan's presentation to his conjecture that "this is what he [Pavan] imagined when he put down the copy of USA Today in the Delhi hotel and decided to become an internet entrepreneur" (Lewis 181). However, this technique of giving grand and incomprehensible answers to questions goes back to ancient times. Plato, the ancient Greek philosopher, wrote the book *Meno* describing Meno, a young and ambitious politician in ancient Greece, and his search for how to acquire virtue, the most coveted characteristic in Greek leaders. In the introduction, Meno finds Socrates and asks him this question. Socrates quickly realizes Meno sounds intelligent, but has no intellectual basis for his assertions. This is further reinforced by Socrates's knowledge of Meno's teacher, Gorgias, who was infamous for giving "grand and bold answers" (Plato 70b), insinuating that Gorgias's answers sounded intelligent, but

wholly lacked in content. Meno is unknowingly guilty of the same fate, and when exposed by Socrates becomes defensive and accuses Socrates of sorcery, stating that no one has ever questioned him before Although not mentioned in *Meno* the intended audience knows that Meno eventually goes on to betray the Greek army, and Plato's commentary is most widely interpreted as the inability to give insightful answers coupled with no questioning leads to the downfall of character and outcome. Although this characteristic is non-unique to stock markets, (it will happen in other structures where power is prevalent, evidently governments) free financial markets are the inherent structure that provides the opportunity to exercise this human characteristic. Lewis ignores the role the underlying system plays in fostering these characteristics. This is not a question of blame, but rather understanding where incentives come from and how they are aligned to action. With the *Meno* analogy, the Greek government is the stock market, the underlying structure by which incentives are derived, and *Meno* is Pavan, the agent of eventual chaos from a lack of intellectual understanding. Just as Meno led to the downfall of the Greek government, the archetype of Pavan was one of the most direct catalysts for the dot com crash. However, the analogy extends further than this. Just as Meno stated, he had never had his answers questioned, this is the same circumstance by which Pavan operates as none of the bankers at Morgan Stanley were willing to question Pavan's logic any further. This bystander effect is also a direct cause of the market crash. Debates can be had about whether the fault lies more with the founder or investor, but understanding the complex incentive structure interaction that emerges from the stock market, rather than simply the action itself, is critical to understanding how markets operate and how to mitigate risks. Just as governments impose regulations against bribery and corruption to mitigate destructive actions, free markets (almost

paradoxically) may need further regulation or framework to mitigate these destructive human tendencies.

Black Monday, or the 1987 U.S. Stock Market Crash occurred during Lewis's time as a junior bond salesman at Soloman Brothers. After his time at the investment bank, Lewis wrote *Liar's Poker: Rising Through the Wreckage of Wall Street* which negatively depicted the banking hub. Black Monday was a new type of crash and many Wall Street banks, including Soloman Brothers, saw enormous losses. In the moments of Panic Lewis depicts a polarized scene. Traders had placed bets all across the board, with some resulting in gains and others in losses. Lewis describes how a "lucky man had gone short S&P stock index futures on Friday, and by the time he had a chance to close out his bet on Monday the futures were 63 points lower, and he had cleared twenty-seven million dollars. His joy was unique. The rest of the equity department was tossed between confusion and despair" (Lewis 36). However, when the firm was forced to make employee drawback from financial setbacks due to the equity markets, the "area [equities] most directly overstalled was the one that made no cuts" (Lewis 38). This hypocrisy illustrates the greed of Wall Street firms and how clouded their decision-making can be. Further than this one example, a common theme of *Liar's Poker* is the lack of integrity and frankly disgusting habits normalized in the banking world such as yelling at and insulting financial experts who talked to them and calling phone sex lines, then broadcasting them over the company's intercom. This behavior further reaffirms the assertion that working in the midst of financial markets brings about immoral action.

Investment banking is seen as one of the most stressful and demanding career paths young professionals can take, routinely working 80 - 100 hours a week. This demanding work

schedule theoretically sets up excellent exit opportunities to private equity or other high-paying jobs, and Lewis writes, “After all, what possibly could the point of being an investment banker if you didn’t make more money than everyone else” (Lewis 178). This prioritization of money above all else inevitably induces negative human behavior. My thesis here is not to assert that society should change markets to exclude toxic cultures and long working hours; however, perspective needs to be developed around how the underlying structure affects emergent behavior and incentives.

Lewis’s introduction to part four, “The People’s Crises” or the 2008 financial crisis uses the word blame nine times on the first page. Profiling certain parties who believe other parties are at fault and vice versa. This attempt to rationalize actions or outcomes through external blame is a defining factor of financial panic. Take even the 1987 U.S. stock market crash, any variety of factors were consistently blamed as the cause for the panic. From computerized trading to faulty mathematical assumptions, market participants rarely own their own blame. People were willing to go as far as blaming math and the creators of complex mathematical functions instead of addressing the idea that it was their misunderstanding (or no understanding) that caused the panic. However, to address where the “blame” for financial panics lies, a new theory may be asserted: Free financial markets are completely random. Of course, market trends and cycles exist, but consistently predicting when or why these cycles will occur is relatively impossible. In an excerpt from Eric Weiner, economist Henry Kaufman attempts to fend off reporters by “pointing out that there is no analytical way to specifically forecast an extraordinary event such as a crash happening tomorrow” (Lewis 50). Furthermore, during the crash of 1987, when Lewis was with an English Soloman Brothers managing director, the director proposed

they threaten the English government with the assertion that another crash would ensue if the government did not buy back the shares at the original price. Lewis's perspective on this experience is one of shock as “he [Enlglish director] was so desperate to avoid the losses that I think he actually believed his own lie” (Lewis 41). These examples show rationalization materializing in two different forms. With the pure amount of information that exists to contextualize markets and make predictions, it seems possible to utilize the data effectively to generate above-average returns. While it may be, Peter Lazaroff from Forbes writes, “investors tend to gather confirming evidence when making investment decisions rather than evaluate all available information” (Lazaroff 2016). This evidence is directly aligned with the quote above as people will seek out information or rationalize decisions that aid their perspective in establishing some semblance of security. Like a child clutching a security blanket, investors hold onto the idea that stock market volatility can be highly predictable, and if the delta between the expectation and actual outcome differ, inevitable rationalization will take place to calm the mind. Lewis highlights this phenonemem many times throughout the book, but he seems to indiviualize the circumstance to the person. In the example above with the English MD, Lewis comments on the absurdity of the assesterion, but supplements that by saying that he knew what the truth was. By approaching the argument in this way, Lewis subtly places the issue solely with the man. The ignorance of the underlying incentives a free financial market places on the psychology of market participants is key missing feature to understanding how and why markets operate in the way they do.

Lewis profiles four different financial panics, giving the reader an in-depth perspective on the moments leading up to and the crash itself. Lewis asserts that the two main drivers for the

financial crises are inadequate comprehension of market factors, and deficiencies in human perspective. Both of these conclusions are agreeable, however Lewis fails to dig deeper and profile the underlying system, free financial markets, that breed these tendencies. In each example, Lewis seemingly individualizes the problem to a person or situation. By approaching arguments in this manner, Lewis fails to identify that emergent properties of free financial markets incentivize incurable characteristics of human behavior. Free financial markets have clear incentive structures, relating to both money and power, and as seen throughout history, people will overstate their knowledge of any situation or topic in an effort to sound intelligent. Lewis often attributes these intellectual overstatements to new technology such as computerized trading or complex mathematics, but the same root issue is the cause of this human characteristic. Of course, financial markets are not to "blame" for these issues, but understanding the structures of markets and why they incentivize action that inevitably leads to catastrophe is critical to "show how financial markets now operate", the purpose of the book. Lewis does establish that deficiency in human morality or behavior is a cause of these panics, but he fails to connect these deficiencies back to the incentivizing source itself, markets. This nuance may seem trivial, but it brings up a chicken in the egg problem. Does market volatility lead to immoral behavior or does immoral behavior lead to market volatility. Lewis asserts the latter, whereas if a deeper connection were understood of how the human psyche interacts with power structures, the market volatility would be seen as the cause for this negative human behavior.

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