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Market Cycles and Fraud

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Jim Chanos is probably the best short seller in the world and has spent his career searching for frauds and companies with questionable business models including the likes of Enron, Tyco and more recently Valeant Pharmaceuticals.

While we stay away from short selling (i.e. wagering that a company's share price will fall) we listen intently to what rational short sellers have to say and Chanos is as rational as they come. According to Chanos, there is a strong correlation between great episodes of fraud and the financial cycle and large frauds have often occurred at the tail end of financial cycles.

At the start of the cycle, lower interest rates leads to an increase in demand for goods and services. Assets like stocks and houses also start to appreciate and people become wealthier. As the cycle continues and you see your neighbours getting rich, the fear of missing out kicks in and leads people to make more questionable investments. The economic historian Charles Kindleberger summed it up perfectly. He said: "There's nothing so disturbing to one's well-being and judgment as to see a friend get rich."

As investors turn down the dials of scepticism in search for the next big thing, they can fall prey to fraudsters.

Low interest rates and naive investors create a breeding ground for financial fraud. It can go undetected for long periods but eventually will be found out. The number of these episodes in both public and private markets has been rising since 2016 including the escalation of speculative investments in cryptocurrencies and fraudulent ICOs (initial coin offerings).

One of the largest scandals involved the biotech company Theranos. The company had a great story. They claimed to have invented a device that gave speedy blood tests for a range of diseases from only a small sample. They had an impressive ensemble of board members among them the economist George Shultz and former US Secretary of State Henry Kissinger. They also had an enigmatic CEO and the company's value was on the rise. The company was valued at $9 billion in 2015 and today it is valued at $0. Adjusting for lawyer fees, its value may actually be less than $0.

Smart investors were coaxed into investing because of a fear of missing out. As is typical in the late stages of the financial cycle, people suspend disbelief in favour of making a quick return.

The increased instance of corporate fraud around the world is an indicator of the latter stages of the financial cycle and partly explains why we have been defensively positioned over the last two years.