The insider story - Michael Milken case

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I never thought he'd make it. I thought he didn't have the personality. In social situations he'd just sort of stand there with his shoulders hunched and his hands in his pockets, with this fixed grin on his face. He had his own ideas, but you could never really figure out where he was coming from. He was a loner.'-A former bond-trader remembers Michael Milken from the early 1970s.

BY THE TIME I arrived at Drexel Burnham Lambert in 1985, in something less than a Mistress of the Universe capacity, Milken's demeanor hadn't changed much. But he had undoubtedly made it-or at least a couple of hundred million dollars of it. It would take Rudolph Giuliani to establish Milken as a household name. But then, as Milken himself liked to say, "No one ever made a dime off publicity."

A 600-million settlement and a potential 28-year jail term have, no doubt, reinforced his opinion. At the astonishingly early age of 43, Milken's brilliant career has ended. On April 24 he pleaded guilty on six felony counts in New York's federal district court.

Milken's fall has been received with gloating far beyond that which routinely accompanies the discomfiture of anyone nominated as a symbol of the Reagan era. Richard Breeden, the Bush Administration's chairman of the Securities and Exchange Commission, called for "a substantial period of incarceration ... Mr. Milken's admissions demonstrate that he stood at the center of a network of manipulation, fraud, and deceit."

What had Milken done to deserve such execration? This remains curiously unclear. The six felonies to which he confessed were essentially technical. They were a small fraction of those alleged by the prosecution in its 98-count indictment and included no racketeering or insider-trading charges; the actions in question had not directly enriched Milken himself.

Above all, they hardly demonstrated any fundamental flaw in the junk bond" market, which Mr. Milken pioneered and which remains breathing if battered. In fact, since December 31, 1989, junk bonds have outperformed equities, losing 1.65 per cent of their value, according to Shearson Lehman, compared to a loss of 3 per cent in the S&P 500. While there have been few new issues thus far in 1990, it is noteworthy that rival Wall Street firms fell over themselves to hire any refugee from Drexel's Corporate Finance Department with a few clients in his Rolodex. It will be left to some future financial historian to uncover Mr. Breeden's "network of manipulation, fraud, and deceit."

As the Wall Street Journal noted, any claim that the existence of this network" is implicit in Milken's confession must be subject to "the presumption of RICO." The Racketeer-influenced and Corrupt Organizations Act was intended by Congress for use against gangsters. It involves such savage sanctions-for example, seizing defendants' assets before trial that it effectively rubber-hoses into submission the white-collar types to whom it is now being applied by aggressive prosecutors.

A Better Mousetrap

THE KEY question about Milken is Emerson's: Did he build a better mousetrap? Indeed, are better mousetraps ever possible in financial markets?

The device at issue is the junk bond." The term originated to describe the phenomenon that occurred when companies got into difficulties, causing the price of their outstanding bonds to fall. This effectively increased their interest yield to investors brave enough to buy them at that point.

Milken began by putting into practice academic research he came across while still at the Wharton business school: buying a wide enough range of junk bonds would theoretically yield enough interest and capital gains to compensate for the risk that any one of the underlying companies would go bankrupt. Then he took junk bonds, and his increasingly enthusiastic clients, through two further steps.

I new high-interest bonds for companies not previously thought creditworthy, reasoning that standard criteria must just be too cautious. This is the chapter of Milken's story on which his hagiographers like to focus. And indeed, the approximately fifty growth companies that originally issued high-yield debt and were subsequently upgraded to investment grade by the credit-rating agencies-for example, MCI Communications, Humana, and Zayre-indicate that there was at least some truth in his thesis.

Second, Milken decided that junk bonds could be issued to finance the takeover of major corporations whose assets could be made to work harder. This proved equally valid-the process no doubt accelerated by the great cycle of inflation and disinflation through which we passed in the 1970s and 1980s, leaving corporate assets undervalued by the stock market.

Milken unquestionably extracted monopoly profits from his pioneering efforts. He used to tell us that these profits would diminish as the junkbond market matured and became more efficient over time. Perhaps this accounts for his unremitting pursuit of more deals long after he had amassed riches beyond the dreams of normal avarice. Or perhaps he was just pathologically aggressive. I never knew anyone at Drexel who reported Milken as anything but polite and soft-spoken. But he surrounded himself with a Beverly Hills sales force that was a notorious goon squad.

Predators' Ball

HEALTH never changed his modest lifestyle or relentless work ethic. I remember him late one evening at the "Predators' Ball" the annual clients' conference in Beverly Hills which cost scrillions, including millions for such minor items as flowers and limousines. While every pipsqueak with a Drexel business card was holding court in places like the Polo Lounge and Chasen's, the most powerful financier in the world was quibbling over the rush charges on slides he wanted made up overnight for his keynote address the next day. "If it's 100 per slide, have them produce them all," he specified, but if it's $300, I only want these ten."

In the end, it was Milken's power, not his greed, that excited a remarkable number of old and some quite new antagonisms. "Main Street," America's commercial heartland, has traditionally resented the high-paid financial city-slickers upon whom it depends for capital. And entrenched managements were secretly happy to believe Professor John Kenneth Galbraith's complaint that they had usurped the rights of the shareholders who technically owned their companies and had become a self-perpetuating "technostructure." Milken showed they could be displaced by his undreamt-of species of monster takeover, briefly reasserting the supremacy of shareholders' rights. (In the aftermath of Milken's fall, there is an illusion that the boardroom has emerged insulated from the authority of the shareholder ballot box. But the Left abhors a vacuum. It can be counted upon to nominate the government to fill it.)

Above all, Milken attracted the jealousy of America's powerful "New Class," the social grouping that Irving Kristol has identified as making its living through its influence on the government's power to spend, regulate, and legislate. This includes professional politicians, their hangers-on in the media and academic life, and much of the ever-proliferating legal profession. Rudolph Giuliani, in fact, seems to have thought that his crusade against Milken would help elect him mayor of New York.

Significantly, there are now ominous signs that Washington is eager to lay as much as possible of its responsibility for the savings-and-loan mess at Milken's door. This of course is nonsense. The thrifts were in trouble as a direct result of federal policy long before the junk-bond market cratered. And at most, it is estimated that 1.4 per cent of S&L losses, or some $14 billion, represent losses on junk-bond holdings.

The whole truth about the Milken phenomenon will not be known for years. But it is disturbing to compare this case with the results of an earlier discovery of a better financial mousetrap. At the turn of the century, J.P. Morgan was attacked for taking a similar quantum leap in risk by financing major takeovers through the nascent markets for publicly traded common stocks, which paid little or no dividends and were not secured by any assets. The institutions he built-Morgan Guaranty Trust, U.S. Steel-are now part of America's financial establishment.

In making a market Morgan was legally able to do much that Milken could not. The complex securities legislation passed amid populist outrage after the 1929 Crash, arguably misconceived and certainly subject to unpredictable judicial and regulatory reinterpretation, has caused many denizens of Wall Street to resign themselves to being perpetually open to charges of having violated some regulation or another. Milken himself was obviously a risk-taker of heroic proportions. The ultimate question is whether the American system needs and can still accommodate such personalities.

Or, as Drexel used to proclaim on its mugs and T-shirts, "No guts, no glory."