Readings

Exploding the Myth of "Junk Bonds"

Junk Bonds: How High-Yield Securities Restructured Corporate America
by Glen Yago
(The Oxford University Press, 1991), 249 pp.

Reviewed by M. Wayne Marr, Jr.

Glen Yago traces the rise and decline of the high-yield securities market. In his analysis of *Junk Bonds* he weeds out myth from reality. High-yield securities have been called "junk bonds," "swill," and "scrounge" by the press. Their creator, Michael Milken, was convicted, and his firm Drexel Burnham declared bankruptcy when it was unable to pay $2 billion in credits including a $650 million government fine.

But Yago's incisive analysis shows that junk bonds had some inherent, good attributes that made them popular among the noninvestment-grade, small and medium-sized high-tech and innovative firms. These "junk firms" became the engine of growth for the U.S. economy. The press has associated junk bonds with declining productivity, layoffs, and plant closings, but Yago proves that high-yield financed firms experience rising productivity as well as increases in employment and sales. Critics associate junk bonds with leveraged buyouts (LBOs) and management buyouts (MBOs), but high-yield securities actually formed a small percent of the total financing of LBOs and MBOs.

The decline of junk bonds started with the rising popularity and acceptance of antitakeover defenses by firms and states. As junk bonds were held responsible for the failing savings and loans, insurance companies, and banks, portfolio managers avoided the bonds. Yago blames the negative campaign of the press and the political clout wielded by large companies facing takeover threats as the culprits that led to the demise of junk bonds.

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If junk bonds were so deleterious to the economy, what led to their rise and popularity? In the mid-1970s many large American businesses began losing their competitive edge to quick thinking and technologically advanced international firms. Deregulation and competition forced banks to pay higher interest rates to depositors. The banks made up for the loss of revenue by lending to corporations at higher rates. At the same time, interest and inflation rate volatility made fixed-rate funding attractive to corporations. Junk bonds provided an answer.

Junk bonds allowed easy access to capital to many noninvestment-grade firms that had innovative ideas and products to contribute to the American economy. Therein lies the true revolution caused by junk bonds: the concept that a company should be judged on its potential, rather than on what it has previously accomplished. The $7 billion generated by 6 percent junk bonds allowed Charlie Flint of Computing-Tabulating-Recording to develop and rename his company International Business Machines in 1924. Since then General Motors, Goodyear, and many others have used this tool of financing. Today, working families might leave their children in a daycare center financed by high-yield bonds (Kindercare or Le Petite Academie), seek medical treatment through high-yield-financed health care (Maxicare, Salick, and Charter Medical), read a high-yield book (Macmillan or Maxell), go to work at any number of manufacturing and service companies financed by high-yield securities (steel, paper products, chemical processing, financial services), return to high-yield-financed homes (Hovnanian Enterprises), let their children watch cable television (almost exclusively financed in the high-yield market), and go out to shop (Macy's), eat (Chi Chi's or Denny's) or see a movie (Lorimar, Warner, or Orion)—all activities made possible in part by junk bonds.

Junk bonds have increased economic participation for a broad range of firms. Companies have used debt to increase employee participation by allowing both management and employees to become equity owners. The earlier fights over dividing the shrinking

pie in corporate wealth have given way to ways and means of increasing the size of the pie. Labor productivity has increased, and the number of layoffs has decreased. Both the employees and management are equally responsible for losses due to seasonal and cyclical declines in demand. Junk-bond-fueled management and employee buyouts have democratized the economy by allowing small and medium-sized firms to create wealth without having to rely on government redistribution programs.

In financing the growth plans of entrepreneurial firms, high-yield bonds enabled companies to restructure in ways that better aligned the interests of management, employees, and shareholders. This restructuring has resulted in operating improvements and productivity gains. High-yield firms have consistently outpaced their industry in sales, productivity, employment, and capital spending. Yago has presented extensive statistical evidence to build a case for junk-bond-fueled firms. Graphs accompanying the lengthy data have made the analysis easier to follow, but the story is essentially written for specialists in corporate finance. Yago has presented case studies to support his aggregate analysis. By classifying firms into various sectors, he proves that the productive effects of junk bonds are not unique to one industry.

A myth about junk bonds has been that they exclusively financed LBOs. Yago found that junk bonds accounted for 15 percent of the total financing in LBOs. The balance was financed by banks and internally held funds. Critics have associated junk bonds with greenmail payments during the takeover attempts by Carl Ichan and others. By adopting various antitakeover measures for "shareholder protection," management has minimized shareholder wealth as shareholders failed to realize the attractive takeover premium. This management insulation couched in the garb of shareholder protection has evoked profound fear and revulsion among the public and press for high-yield securities. LBOs have been labelled as "paper shuffling," "shell games," and "ponzi schemes" by the critics.

Yago systematically studied 113 LBOs and found that the debt incurred in an LBO does not drain productivity, nor does it cause reductions in R&D spending, layoffs, or plant closings to pay off the debt. He found that the relative productivity increases were "the result of lower input growth, perhaps reflecting managers' incentives to carefully monitor costs among LBO plants, rather than higher output." This rise in productivity may be caused by selling off unproductive plants: a point that Yago has not considered. The main purpose of LBOs is to sell off unproductive units of the target. Hence the post-LBO units will be the productive units with lower overall costs.

In tracing the decline of the high-yield securities market, Yago blames the antitakeover provisions implemented by various states at the behest of large corporations facing takeover threats. Several states competed to legalize a variety of antitakeover provisions to create a favorable environment for corporations so that states could earn high corporate franchise fees. Corporations treated the state governments as their "banana republics" when it came to implementing antitakeover provisions.

With the indictment of Michael Milken, the father of junk bonds, Drexel Burnham lost its market share and finally declared bankruptcy. As junk bond securities were blamed for substantial losses in the portfolios of failing thrifts and banks, federal regulation had these institutions reduce their junk bond holdings. This led to an excess supply of junk bonds. But Yago failed to explain why pension funds, the largest players on Wall Street today, did not play the junk bond game. Surely pension fund managers would hardly be swayed by press rhetoric.

Glen Yago has written his book with a mission to explode the myths surrounding junk bonds. His enlightening analysis should have been published three years ago, when the government began systematically crushing the high-yield market. His analysis will be useful for implementing a high-yield securities market in the international capital market—a likely outcome, given the integration of global capital markets.

Demobilizing the State

Quicksilver Capital: How the Rapid Movement of Wealth Has Changed the World
by Richard B. McKenzie and Dwight R. Lee
(Free Press, 1991), 315 pp.

Reviewed by Paul H. Rubin

If this book is correct in its predictions, most readers of *Regulation* will be delighted. (Those who favor a larger and more influential state will be less pleased.)

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"THE FCC SAYS 'YES', THE FTC SAYS 'MAYBE' AND THE SEC SAYS 'NO'."

The argument is simple but powerful: Increasing mobility of capital limits the power of governments to tax or regulate because capital can move to avoid the consequences of government actions. If the thesis is accurate, then the book will be significant, and we may expect the future to be bright since there will be more wealth and less government presence in the world. The forecast in *Quicksilver Capital* is sufficiently probable to make reading it clearly worthwhile.

The driving force behind the analysis is technological change, and particularly change in electronics. At least three features are involved. First, reduced size and increased flexibility of electronic and related capital equipment means that more and more capital is easily movable across national boundaries. Second, capital is increasingly in the form of information, much of it in the brains of skilled people, and this capital is also easily and cheaply movable. Finally, and perhaps most important, change in the technology of information processing makes financial capital increasingly mobile.

Because of this increased mobility of increasingly important forms of capital, governments have decreasing power to control behavior. This reduction in possibilities of control means that taxes will be reduced and that there will be less regulation as well. This occurs because owners of movable capital can easily escape attempts at appropriation of wealth though taxation or at control of wealth through regulation by moving their capital to another jurisdiction.

McKenzie and Lee indicate ways in which this reduced control has already occurred. The most dramatic global evidence is the dismantling of the Eastern bloc and the collapse of communism. Reaganism and Thatcherism are attributed to the same causes. There is additional evidence of a more microeconomic nature as well. The authors detail carefully the leveling off in the share of GDP going to government and to taxes in many developed countries in the 1980s, and the actual reduction in top marginal tax rates. They also provide somewhat more impressionistic evidence for a decrease in regulation and for an increase in privatization in the United States and in the rest of the world.

McKenzie and Lee emphasize throughout that their vision is different from past analyses of the effect of technology on government. Analysts from Marx to Hayek (in *Road to Serfdom*), including Milton Friedman and James Buchanan, have forecast an increasing role of government based on predictions of increasing economies of scale in both production and in governance technology. The authors of *Quicksilver Capital* argue, however, that diseconomies in these activities have set in at a relatively small scale and thus lead to smaller optimal size of many organizations. The predictions of the past, therefore, are not likely to hold. Their vision is also optimistic and promarket, in stark contrast to many books forecasting "the end of laissez faire" and the "fall" of the United States as a great power.

The book has implications for policy. McKenzie and Lee claim that their view both explains current and likely future policy changes and provides guidance for such change. Some examples:

- Technological change (for example, fax machines) has eroded the significance of the postal monopoly.
- Improving technology of monitoring is making private roads and highways feasible.
- Various sorts of change are reducing the value of government regulation of "natural monopolies."
- Internationalization of markets has eroded the significance and importance of antitrust.
- Ease of avoiding government is limiting the ability of special interests to use government power to effect transfers.

- Many drugs will be legalized, or at least efforts at control will be reduced, because costs of control in a world of mobile capital and cheap communication will be excessive.
- Immigration restrictions will be loosened.
- There will be increasing liberalization of international trade.
- Requirements for a competitive labor force will necessitate shifting education towards some sort of free choice or voucher system.

Like the book overall, these forecasts are optimistic. We must ask how likely it is that the predictions of McKenzie and Lee will come true.

McKenzie and Lee have chosen to present their analyses and predictions first in a trade book. This is a legitimate forum for predictions as large, important, and general as these. It may be important for general audiences (as opposed to specialized audiences of economists) to have quick access to the results. Presentation in this way does have costs, however. The arguments and analyses are not subject to the peer-review process imposed on authors by scholarly journals. Moreover, the types of statistical analyses usually relied upon in professional journals are lacking here.

For example, many predictions in the book depend on levels of use of technology. The fifty U.S. states often provide a useful laboratory for testing hypotheses such as those in *Quicksilver Capital.* Tests could be performed to determine whether there are significant relationships between variables such as average level of education or use of computers in states and levels of taxation, migration, and regulation. Alternatively, statistical time-series analyses for the United States as a whole or cross-section analyses using countries or industries as data points could also be tried. McKenzie and Lee do cite evidence from journals related to their arguments, but direct tests inspired by a hypothesis are always preferable to indirect evidence from previous analyses. The authors have provided an interesting series of hypotheses to be tested, and one hopes that they or others will begin the formal testing process.

Events occurring since this book was written have not always been in line with its predictions. Mrs. Thatcher is out of office, and President Bush does not seem to be carrying forward the Reagan Revolution. The book predicts that "[i]f a lower capital-gains tax has not been passed by the time this book is in print, it soon will be," but such a decrease is not yet in place and is apparently not currently high on anyone's agenda. Although not much time has passed since the book was written, the book is itself based on a relatively short interval. Thus, a period of a few years is a significant fraction of the time involved in the predictions of the book.

This raises another question. It is well known that governments undertake many actions that reduce the wealth of their citizens. Even if McKenzie and Lee are correct, what is to stop governments from increasing taxes and thus lowering the wealth of citizens? As I write this, we are in a recession that may have been caused by the Bush increases in taxes and regulations. Indeed, if McKenzie and Lee are correct, the current recession may have been caused by the government's ignoring the very forces that these authors identify as constraining government. If governments are willing to see real incomes fall, even mobile capital will not fully constrain them. Moreover, as the fate of the "read my lips" promise shows, even in a democracy where citizens express strong desires for tax limits, they may not be able to obtain such limits.

Where does this leave us? While its predictions are not guaranteed, the book is definitely worth reading. It is certain that many of the trends discussed in the book are real; the only debate is the magnitude. *Quicksilver Capital* provides an alternative to bleak forecasts of more government and the decline of the United States, and it is better argued and better grounded in economic reality than its competitors from the left.

Finally, the book may well be correct in its predictions. Those of use who would like this to be the case deserve to treat ourselves to reading an encouraging and credible forecast of the future.