

# **There Will Be Better Days to Come**

**An in-depth analysis of three stock market crashes.**

**Theories, Reactions, and Results from economic misfortune.**

**Senior Honors Thesis**

**by**

**Robin Anne DeLay**

**Finance Major**

**Thesis Advisor**

**Mark Myring**



**Ball State University**

**Muncie, Indiana**

**December 9, 2002**

**Graduation**

**May 2003**

## **Abstract**

The thesis I wrote is designed to explore and evaluate three major stock market crashes that have stunned our nation since its creation in 1896. The three market crashes were in the years 1929, 1987, and 2001. Each of these crashes were unique in nature and resulted in a government entity, a market tool, and an overall education of market participants.

The market is a risky tool used for investing, but average returns realized by using this trading mechanism have proven to be bountiful. Higher risk in investing in the stock market has rewarded investors higher returns than by using other means to invest. The market baffles many, even those investors with years of experience and success. Yet, we investors continue to invest our money in the stock market.

There is one point agreed upon by many. Investors must be educated and not make rash decisions when buying and selling securities. It is this rash behavior that creates market crashes. A rational investor will hold securities when times are bad, for he or she knows that there will be better days to come in the future of the stock market.

The stock market is a very volatile exchange that is complex and baffles participating buyers, sellers, and traders by its highs, lows, and intense changes. The Dow Jones Industrial Average, NASDAQ, Standard and Poor's 500, and other worldly exchanges change value and volume daily and are monitored closely by participants. Daily fluctuations are a norm in the stock market. Three individual times in the history of the stock market, these fluctuations were extreme and the market plunged, creating mass havoc among the trading world. The three instances were in the years 1929, 1987, and 2001. Although there have been other days of massive losses in the history of the stock market, each of these occurrences were very unique in nature and have resulted in changes in the daily cycles of trading. The bottom line of all stock market crashes and scares is that there was not one individual factor that was the cause; multiple factors caused each crash and improvements in trading were made to avoid future failures.

### **Background of Trading**

The Dow Jones Industrial Average is the most widely domestic trading mechanism. The NASDAQ, Standard and Poor's 500, and other exchanges take a backseat to the Dow Jones, but are also major players in trading. First created in 1896 by Charles Dow, the initial name for this exchange was the Dow Jones Bergstressen Industrial Exchange. This exchange consisted of twelve domestic corporations, mostly comprised of various railroad companies, National Lead, and U.S. Rubber. The first measurement in value of the Dow Jones was a meager 40.94

points. In comparison, the highest mark the Dow Jones has seen came in year 2000, at a value of more than 11,300 points. The Dow Jones exchange has seen immense growth in its more than century of existence.

### **The 1929 Crash**

The years of 1928 and 1929 showed a great leap in the Dow Jones Industrial Average, from a low of 191 points in 1928 to a high of 381 points in September of 1929. Also during that time, the average Price/Earnings ratios doubled from 10 to more than 20. (The Price/Earnings ratio is price per share of stock divided by earnings per share). The change in P/E ratios was due to an anticipation of further prosperous times in the stock market. Analysts differed in opinion about the valuation of stock; some analysts believed that stock prices were overvalued, while others argued that prices were undervalued. This difference in opinion was about to be solved (Rothbard 28).

Even before the infamous October of 1929, June of that year showed great promise that October was in the making. On June 12, 1929, over five million shares of stock were traded. Prior to that day, it was a joke around Wall Street that a volume so high would ever be traded on one particular day. As a New York paper described this day, "Wall Street's Bull Market Collapsed Yesterday with a Detonation Heard Round the World" in a very memorable headline (Galbraith 20).

As the panic began, the New York Times published an article on Sunday, October 20<sup>th</sup> to set the public straight about the favorable and unfavorable conditions

of the market. The favorable factors included stable business conditions, low money rates, and good retail trade. Among the unfavorable traits were new common shares being issued by numerous corporations, inflated stock prices, and a nervous market. The negative factors would soon outweigh the positive (Bierman 62).

On October 2, 1929, stock prices started to drop. This behavior continued into the week of October 14<sup>th</sup>. This "bear" market turned from bad to worse on Monday, October 21<sup>st</sup>, when many Dutch and German investors submitted sell calls that came into effect the next morning. On Tuesday morning, numerous banks and corporations called over \$150 million in loans, and because these loans were illiquid, that sent investors into a craze (Rothbard 47).

After a month of negative signals, investors began to sell their stocks quickly. An extra three hundred members of the New York Stock Exchange were on the floor that day, in a hopeful attempt to dump their stock while it was going down in price by the minute. That day, the Dow Jones Industrial Average closed at 299 points (Young 33).

On the morning of October 29, 1929, the inevitable crash was becoming apparent in the eyes of investors. Within the first several hours of the opening of trading, the overall prices of stocks dropped so much that any gains from within the previous year were wiped out. That day, the market closed at an astonishing 230 points, closing almost at the level it had been a year earlier. The losses of October 28<sup>th</sup> and 29<sup>th</sup> were 12.82% and 11.73% respectively (Young 36). These

percentages were computed later than normal, for systems were running an hour behind schedule, an occurrence that rarely happens.

The worst performing stock of the day was that of Auburn Auto, which was very bad news for Groucho Marx, a major shareholder of the company. The giant assumed that he had enough money invested to cover any losses and cover his margins, and he luckily was able to do so, but all of his profits were lost. He lost an undisclosed fortune that day (Klingaman 256).

In the months and years following these two historic days, all faith in the American economy was lost. Investors pulled their deposits from their banks, up until the point that many banks closed their doors because much of the deposited money from investors was tied into illiquid loans to borrowers. This behavior was known as a "bank run." Fortunately, such bank runs have not occurred since this era. It was estimated that 11,000 of the 25,000 banks open during this era closed because of bank runs (Young 48).

Because money was scarce and average incomes decreased by almost half of their original worth, demand for consumer products and services went down, resulting in a decline in consumption, inevitably resulting in an increase in unemployment. This cycle started in the months following the stock market crash and lasted until 1939. Another factor that compounded the destruction of the financial system in the United States was that the U.S. financed a good portion of World War I. After the financial distress started, the United States' government had difficulties repaying loans taken out from France and Great Britain. This, in turn, had

negative effects upon the French and British economies, and, in turn hindered international relations (Young 29).

A poem was published in the Wall Street Journal soon after the great crash. It perfectly illustrates the 1929 crash (Klein 207).

“Rock-a-bye, trader, on the tip top.

When the Board meets, the market will rock.

When the rate rises, quotations will fall.

And down will come trader, margins and all.”

This poem describes how the government and Federal Reserve were able to manipulate the successes and failures by implementing monetary policy and how negative reactions “rocked” the market. When interest rates rose, stock prices dropped, for borrowing money became more expensive (Klein 208).

### **Theories Explaining 1929 Crash**

There were many main theories that were derived after the devastating stock market crash, the most notable following. None of the following were the single cause for the crash, instead, all of them together led to the crash.

Many analysts believed that stocks were overpriced. Since early investors believed that the stock market was simply a quick way to get rich, they did not fully study their prospective companies and invested in whatever appeared to be profitable at the time. The shares of stock reached levels at which they did not reflect the true value of the company because investors continued to invest money in

particular shares of stock, driving up the price per share. This is illustrated by the fact that Price/Earnings ratios almost doubled. When it was finally realized that stock prices were highly overvalued, investors tried to quickly sell their stock, making the price per share plummet.

Another theory surrounding the crash is that there was rampant fraudulent and illegal behavior by investors and politicians. Individuals were suspected of insider trading, for it was believed that these traders held information that was not readily available to the public, and that they used this information to sell their stock before the news spread to the majority of investors. By selling before the information went public, they were able to sell their stock before the prices started to go down.

While the stock market was prosperous and profits were high, investors bought on margin. This means that investors borrowed money to buy their shares. When unemployment started to rise, these loans were not repaid, resulting negatively in the market. The accumulation of these unpaid loans was yet another factor that damaged the dwindling economy.

Leading up until this era, the monetary policy was loose and in a sense, the previous problems in the market had worked themselves out. Soon before the crash, Adolph Miller, President of the Federal Reserve Board, tightened the monetary policy and attempted to lower the overvalued stock prices because he believed that speculation was the source of high stock prices. Also, in the beginning of 1929, the interest rate charged on broker loans skyrocketed. "This policy reduced the amount

of broker loans that originated from banks and lowered the liquidity of non-financial and other corporations that financed brokers and dealers" (Young 72).

Leading up to the 1929 crash, there was a strong craze to invest in the stock market. The reasoning from investors to join the bandwagon was that stock dividends were high and people found themselves earning healthy quarterly payments. Prior to 1928, average annual salaries and earnings were high and there was a surplus of income. Even individual industries had high profits and wanted a share of the pie. The monetary policy was loose and that enabled investors to take out loans with low interest rates to invest in the market. The last reason for the craze to invest in the 1920's was that things were only looking better as time passed. The economic boom was expected to continue. During the times leading into the crash, the rich became richer more quickly than the poor became poorer. They were wrong. As it was once said, "all good things must come to an end."

A change in currency may have upstirred confusion among traders. "The advent of World War I disrupted and rended this economic idyll, and it was never to return. In the first place, all of the major countries financed the massive war effort through an equally massive inflation, which meant that every country except the United States, even including Great Britain, was forced to go off the gold standard, since they could no longer hope to redeem their currency obligations in gold." This theory, though, has little evidence to support it (Rothbard 80).

One last theory surrounding the crash was that soon before the crash, public officials continuously emphasized and publicly stated that the market was

overvalued. Because this mentality was embedded in the minds of investors, this made them very nervous and may have motivated them to sell their shares in haste. Even though the President of the United States, Herbert Hoover, attempted to calm the public and reinforce that he was taking extreme measures to correct the problem, the public was not ready to listen and calmly trade. They wanted out quickly instead (Young 105).

### **Reactions to the Crash**

There was heavy criticism of the Federal Reserve after the crash. Many investors believed that the Fed did not respond quickly enough to the instability of the market. The actions of the Fed included lowering the interest rate two full percentages, from 6% to 4%, in the five months following the crash. In New York, the largest commercial bank sector in the United States, commercial banks made loans to securities dealers and brokers, which provided liquidity those who financed them before the crash. From February 1930 until 1932, the monetary policy became unclear to investors. Government securities purchases declined in the open market, reducing the liquidity that was previously strived for. Interest rates increased twice in 1932, an action that was unexplained by many. This act made loans more expensive to finance and cut down further on dwindling consumption levels in the U.S. The worst act, as viewed by many, was the fact that the money supply dropped 31% between 1929 and 1933 (Young 46).

Throughout history, it has been well known that the Great Depression soon followed the 1929 stock market crash. During this time, domestic production dropped by an estimated 50% and unemployment was at a high of 30%. The overall price levels dropped by about 30-35%. Living conditions were comparable to present-day African countries. It was not until 1939 that light was seen at the end of this horrific decade and conditions began to improve. The United States left this era a little wiser and with a new government entity, known as the Securities and Exchange Commission, which set guidelines and rules about securities buying, selling, and trading. This entity will be described later in the thesis. Also created was the Glass-Steagall Act, which separated commercial and investments banking, which was created to avoid another bank run.

Did the Securities Exchange Commission eliminate all major crashes from that point on? Unfortunately, no it did not. There would be other crashes to come...

### **The 1987 Crash**

With more than fifty years of relative tranquility in the stock markets, the 1987 crash again shook an investment-crazed society. Black Monday, known as the day of the 1987 crash, sent not only domestic markets, but also international markets into a tornadic spin. The financial stability of the United States was in question, not to mention the government, Federal Reserve, brokers and traders, and individual investors.

A week prior to Black Monday, major indexes of market valuation in the United States dropped 30 percent or more. For the next four months, they were often subject to moderately large daily variation. On October 19<sup>th</sup>, the Dow Jones Industrial Average fell from 2,246 points to 1,738 points, losing about 22.6% of its value. In one week's time, the average plummeted by almost one third, with an overall loss of approximately one trillion dollars. This marked the end of a five-year bull run, which indicates that markets are trending positively, with the average value rising from 776.92 in August 1982 to a high of 2,722.42 points in August 1987. The day after Black Monday, the Dow Jones experienced gains of 102.27 points, which was the largest upward single day jump of history to that date (Young 83).

With better technology present than in 1929, the destruction was calculated almost immediately and broadcast nationally. Brokers, traders, account executives, and individual traders across the country committed suicide because their life savings and investments were gone and serious participants viewed themselves as failures. Again, margin purchases worsened the losses of many, and thousands of investors could not cover their margins. They then not only lost their savings, but also owed a great deal of money.

On August 25, 1987, the Dow Jones rose 25 points in one day, setting a record of fifty-six times to do so in a year. Since May of that year, the average had risen 500 points, an average of 100 points per month. This would be the last day of such jumps. The next day, the average went down by 83 points, closing at 2,663, which was still very high at that time. The Dow continued to decline for the next

week. It was at this time that John Kenneth Galbraith formed a theory that the market was heading in the same direction as the 1929 crash. He was about to become an even more esteemed author and philosopher (Sobel 429).

### **Theories Explaining 1987 Crash**

As was the case in 1929, not one single event led to the 1987 crash, but a series of events. Likely theories of this particular crash are as follows.

Technology, usually seen as a wonderful tool, worked against the stock market during this crash. Many computers are preprogrammed to issue a sell order once the Dow Jones reaches a certain average. When the Dow Jones Industrial Average dropped on October 19<sup>th</sup>, hundreds of computers recognized the average dropping below a predetermined amount and automatically issued sell orders. (This is also the case when stock prices are rising. The computers will issue buy orders when the market reaches a predetermined point). When the computers issued these orders, the Dow was overwhelmed and that, in turn, made the market drop even more. With the computers handling very large volumes, each computer could potentially jolt the market.

Computers also enabled the easy manipulation and configuration of data quickly. Data analysis was almost immediate. When the chaotic behavior started, the data configured immediately reflected this, and was conveyed to investors. These investors quickly tried to sell their securities, furthering the mad rush to sell. The moral of the point was that quickness of sales was vital.

During the crash, the trading of many securities was temporarily terminated because there was an extreme volume of orders being placed, the majority being sell orders. Since there were no buyers available, trading was halted. This eliminated all liquidity in certain sectors of the market. "This insufficient liquidity may have had a significant effect on the size of the price drop, since investors had overestimated the amount of liquidity" (Sobel 318). The loss of liquidity made prices of shares drop even more, for no wise investor would purchase in illiquid security.

During the third quarter of 1987, there was an abnormal amount of trading and budget deficits. Large deficits may have led investors to believe that the country was in financial distress and that a crash was inevitable. This would have motivated these investors to pull their assets from the market, starting the mad rush to withdraw money before other investors caught on to the general idea and jumped on the bandwagon.

As was the case in 1929, many investors and analysts believed that the market was extremely overvalued. They claimed that Price/Earning ratios and Price/Dividend ratios were too high. Once this was discussed, others speculated that this was the case and tried to get out before others realized the same thing.

Withdrawing money prior to and during the 1987 crash was very similar to the bank runs of 1929. Investors in 1987 wanted to sell their securities before everyone else did, hence, before the prices started to drop, in order to minimize losses. In 1929, investors wanted to be the first in line at the bank to withdraw their money before the bank ran out of money. "History does not repeat itself, but it rhymes,"

once said Mark Twain (Sobel 431). These two crashes illustrated that speed was the key to minimizing losses.

### **Reactions to the Crash**

In the days after the crash, the U.S. central bank purchased \$2.2 billion in government securities from investors to pump money back into the market for added liquidity. The Federal Reserve also provided help to commercial banks by making a discount window available when reserve needs were demanding. Alan Greenspan, a financial wizard, calmed the public by making announcements that the "Federal Reserve would serve as a source of liquidity to support the economic and financial system" (Young 105). Interest rates on short- and long-term securities to further support liquidity, including the federal funds rate, dropped by 179 basis points in the months following the crash. Banks increased lending to securities firms in the week after Black Monday to finance the inventories of securities accumulated by their customers' sell orders.

These actions, along with the presence of the Securities Exchange Commission and the sympathetic Federal Reserve, allowed for a very quick recovery period, one much shorter than the recovery period of the 1929 crash. Another Great Depression was avoided due to the securitization of bank deposits. Another major success was that the day after the crash, the market rebounded nicely. One last factor that heavily influenced the recovery was that many domestic corporations repurchased a portion of their outstanding shares in attempt to maintain share price.

These corporations felt that any reduction in price per share was unnecessary and that a drop would not properly represent the value of a share. Buying back stock also signaled that these corporations were secure about their companies and that the companies themselves were not in financial danger (Young 37).

After the 1987 crash, there were measures taken to prevent another crash in the future. Circuit breakers, which will be discussed later in the paper, were created to smooth strong market volatility. Even this tool could not calm investors when tragedy struck our country in 2001.

### **Other Observations of the Crash**

The 1987 crash could have been significantly worse had a financial tool not been placed into effect not long before the crash. Eastman Kodak, IBM, Minnesota Mining, Goodyear, Philip Morris, Primerica, Sears, Union Carbide, Westinghouse, and Woolworth's shares were all taken off the market for trade within fifteen minutes of each other. This act is known as a trading halt. This started around 11:15 a.m. on the day of the crash. All of the listed stocks were components of the Dow Jones Industrial Average and might have hindered the average even more had they continued to trade that day. Merck shares had halted trade earlier in the morning at 9:52 a.m. and Dupont had not even opened for trading yet that day. Merck and Dupont alone accounted for about 19% of the average's value, while a combination of all listed companies listed above would have amounted to 36% of the total value of the Dow Jones. These major players would have worsened conditions a great

deal more had they remained on the market for trade. Trading halts proved to be a success that day (Metz 195).

The market conditions of 1987 have been compared to the "tulip craze" that hit Holland in the seventeenth century. Tulips were very popular and extremely high in demand at this time. As more and more requested the blooming tulip, the price increased to an absurd level. People were willing to spend several hundred dollars (calculated to represent present-day U.S. dollars) for one tulip plant (Miller 90). The stock market was comparable to a tulip market in the 1980's. The early and mid-1980's had seen great growth and prosperity in the stock market. It was seen as a quick (and legal) way to get rich, with few perceived risks. More and more people jumped on the bandwagon and started to buy shares in companies they had not even heard of, but bought them because they heard a quip about further growth. People did not even know what the companies that they had partial ownership in even produced or sold.

Since many small-time investors were buying shares, the share prices began to rise. The majority of time, when a share price rises, it is due to the company making a positive public announcement about the standing of the company, new developments, or further growth. No such announcements had been made about the majority of stocks that had experienced major growth in price. These prices were heavily inflated. Investors started to realize this and sell their shares before others realized this also. Soon, everyone jumped on the selling bandwagon and prices plummeted (Miller 90).

## **The 2001 Crash**

During the early hours of September 11, 2001, a group of well known terrorists that had struck the United States in the past made another strike upon the World Trade Center and Pentagon with passenger planes. Terrorists overtook four passenger planes that were to travel across the country and flew one into each of the World Trade Center towers, one into the Pentagon, and the last was deemed to have been on its way to the White House. This last plane crashed in rural Pennsylvania. Over three thousand innocent civilians lost their lives that day and the nation was struck by surprise.

The New York Stock Exchange was closed from September 11<sup>th</sup> until the 17<sup>th</sup>. When trading resumed on the following Monday, the Dow Jones Industrial Average fell 673 points (around 7%) and closed at 8,926.65. Most of this loss, 550 points, came within the first hour of trading. After that crucial hour, trading leveled off and values and volumes calmed. Similarly, the S&P 500 lost 5%, or 53.62 points, and the NASDAQ lost 6.8%, or 115.66 points. This day marked the largest one-day point loss ever. Since the volumes were high, this day did not mark the largest percentage loss ever, for the percent losses were not as high as those in 1929 and 1987 (Schroeder).

It has been heavily debated whether or not the 2001 market decline could be labeled as an actual crash. What constitutes a crash? Indisputably, the crashes of 1929 and 1987 were indeed crashes, for the markets in both cases declined significantly not only on one particular day, but also, the days leading up to the

major decline. When evaluating the 2001 "crash," it has some gray area. The markets never opened on the catastrophic day, yet when the markets did open, there was a significant decline in value. The first day trading reopened, there were 2.4 billion shares traded on the New York Stock Exchange, with a loss of 7.1%. During the following two days, the market declined another 1.8%, falling to the level that it was December 14, 1998 (Schroeder). It is in the opinion of many, including John Francis of Stanford University, that this was a significant enough decline to be classified as a "crash" (Schroeder).

The market was closed from September 11<sup>th</sup> until the following Monday, September 17<sup>th</sup>. The market never opened on that fateful day, for the attacks started soon before trading was to open. The tool used to close the market is known as a circuit breaker, which will be discussed later. The last time the market shut down for more than two consecutive days was in 1914, when the market was closed for near five months as a result of World War I. This was because millions of civilians, investors, and traders were in Europe fighting in the war and few were at home trading (Schroeder). The last time the market was shut down due to direct physical damage was in 1835 during the New York City fire. Government securities trading resumed after two days of being closed, the majority of share trading was delayed until the following Monday.

Overseas, while the U.S. markets were closed, the day after the attack European blue chips dropped 6.1%, British stocks fell by 5.7%, French stocks by 7.4%, and German stocks by 8.5%. The news of the attacks sent the global markets

into shock, and the immediate future was unclear, even for foreign markets. The majority of foreign and domestic commodities (except oil) fell in price, and the big winner the week of the attack was gold. Gold is notorious for being in demand when unusual disasters or catastrophes occur.

After the markets resumed trading the following Monday, another big winner was in the category of defense mechanisms, such as sophisticated weapons and military transportation. It was no surprise that the stocks that were hit the hardest were those of airline companies. American Airlines lost around 43%, while United Airlines lost around 40%. Other areas of disaster came in the insurance industry. Life, property, and casualty insurance companies will be losing billions of dollars to reimburse the families of those lost in the attacks, and to cover the structural damage of the Pentagon and rebuilding of the World Trade Center (Schroeder).

The Federal Reserve promised to pump money into the economy and provide efficient cash. There was an initial fear that banks would be in danger if another bank run occurred. Fortunately, this did not happen. The initial fear was that the market would plunge, for that is what happened in markets overseas. "The biggest worry is the short-term damage this terrorist crisis does to the U.S. economy, which was already bordering on recession," said Gary Dugan, a European equity strategist at J.P. Morgan in London. "There is huge risk-aversion spreading through the markets; people are just selling" (Schroeder). The Federal Reserve also slashed the federal funds rate by a half-percentage-point the day trading reopened. The goal was to instill confidence again in not only the market, but also, the economy.

Investors did not take this action positively, for this action is also a signal of a weak economy.

Right after the attack, hope was looking dim. "Past history suggests the stock market will likely tumble when it finally opens again for trading, but a rebound could follow. The Dow Jones Industrial Average sank 2.9% the day after the Pearl Harbor bombing," according to a brokerage firm in St. Louis. "The U.S. stock market was in a bear market and the economy struggling at the time of Pearl Harbor, similar to its state before yesterday's surprise attack. The Dow average was down a full 9.7% three months after the Pearl Harbor attack" (Schroeder). There is a difference between these two instances, though. During the time of the Pearl Harbor attack, the U.S. population sensed worldly tension; yet last year's attack was nothing short of a surprise.

Besides trying to keep investors calm by prolonging the opening of the markets, opening the markets would have been near impossible. Thousands of New York Stock Exchange employees commute via subway to work. Part of one subway was destroyed; one that was near the World Trade Center. Opening would have been even more difficult without these employees, who found alternative routes to work in the days following the attack.

### **Theories Explaining the 2001 Crash**

Without a doubt, the major cause of the 2001 crash was the terrorist attacks. Our unified nation lost over three thousand lives that day, and also lost a great deal

of consumer and investor faith. Some believed that this was the start of the end and that the future looked very bleak. There was a great deal of irrational behavior and mentality that existed among the population. For example, gas prices rose from around \$1.20 to over \$2.00 per gallon that day in the Midwest, a commodity that was not immediately affected by the terrorist attacks. There were individuals whom quickly withdrew their savings from their banks and preferred to hold cash, rather than risk their money being dissolved in the event another bank run occur.

This kind of irrational behavior also carried over to the stock market. Since many other factors in the economy seemed uncertain, this questionable mentality applied to investing. Investors were unsure that their securities, stocks, and bonds were safe. Many would have immediately sold their securities had the market been open that day. This behavior has been present in the past. When the 1929 and 1987 crashes occurred, investors quickly wanted to sell their stocks and leave the market while prices were still high to minimize losses. Had the markets been open, the same would have occurred in this case. Uncertainty would have led investors to sell, and sell quickly, before the prices declined and losses mounted.

With the markets closed for four business days, the international markets first took the brunt of the shockwave and smoothed the ripples a great deal. Four days of the markets being closed calmed investors and leveled heightening emotions. Although there was still a great deal of trading the day the market reopened, many of the irrational investors turned rational and realized that selling their lifesavings was not the answer and held faith that this shock would pass. The ideal action to

take would be to hold their securities and trade again once emotions had further calmed.

Even before the attacks, the U.S. economy was headed downward. The nation experienced several consecutive quarters of negative growth and earnings and a recession appeared likely to many. The terrorist attacks came at a time of existing uncertainty and negativism in the economy. The attacks were deemed the last straw; the action that sent the economy into a definite recession, according to many.

### **Reactions to the Crash**

Although no new legislation was created after the 2001 crash, as was the Securities and Exchange Commission after the 1929 crash, nor any new financial tools, similar to circuit breakers that were created after the 1987 crash, the U.S. investors came out of the crash a little more experienced and rational. Such disasters cannot be predicted or prevented, nor can any action prior to such events. It is how the investment public reacts to such events that make investors a little wiser.

Currently, the market is still volatile. The market experiences both good and bad days, but in the year since the attacks, these changes have been bearable and investors have reacted calmly to such movements. Each of the discussed crashes has made investors wiser and more experienced. Tools and committees have been created to avoid major future crashes. It is unfortunate that such events make

investors wiser, but in the end, the market has always found a way to be profitable in the long-run and is a very popular way to invest. As always, investing in the stock market is still a gamble. The following descriptions, the Securities and Exchange Commission and circuit breakers, will further explain how markets have improved since the early beginnings of trading.

### **The Securities and Exchange Commission**

The primary mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors and maintain the integrity of the securities markets. The SEC was created in 1934 in answer to a growing need for regulation in the stock market. Prior to the 1929 stock market crash, there was little support for federal regulation in the stock market. When the walls came crumbling down in 1929, investors became aware that some type of regulation was needed in order to insure that such a horrific crash and depression would not take place again.

The Securities Act of 1933 has often been referred to as the “truth in securities law.” The two objectives of this law are to require that investors receive information, financial and miscellaneous, concerning securities that are publicly up for sale and to prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC was created a year later to enforce this act.

The SEC was granted authority over all aspects of the securities and trading industry. This includes the power and authority to register, regulate, and oversee

brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self regulatory organizations (SROs). Aside from individual stock exchange, the SEC also oversees broker-dealers, investment advisors, mutual funds, and public utility holding companies. The SEC works hand-in-hand with Congress, other federal departments and exchanges, stock exchanges, state securities regulators, and various private sector organizations.

The SEC requires that companies fulfill certain obligations. Any company with more than \$10 million in assets whose securities are held by 500 or more owners must file accurate annual reports and other financial data. Any data or supporting material used for shareholders' votes during shareholder meetings must be disclosed and published publicly. This information must disclose all facts concerning the issues that are to be voted upon. The SEC requires disclosure if any information by anyone seeking to acquire 5% or more of a company's securities through either direct purchase or tender offer. This is to prevent a takeover of a company. The SEC also prevents insider trading, which occurs when an individual uses nonpublic information for personal benefit in trading. Employees and their families are monitored in their trading. If an employee or family member makes a purchase or sale right before the announcement of crucial news, eyebrows are raised. This action would most likely be as a result of the investor possessing information before the public was aware of it.

There are four separate, yet unified, divisions of the SEC. The Division of Corporation Finance regulates the corporate disclosure of documents relating to

financial data. The finance division reviews this data and looks for inconsistencies and false reporting. The documents required to be submitted include registration statements for first-time offered securities, annual and quarterly filings (such as 10-K and 10-Q filings), proxy materials distributed to shareholders before shareholder meetings, annual reports, tender offer documents, and filings for mergers or acquisitions. These documents enable investors to stay informed about the performance of the company and allow them to make accurate and proper decisions. All information for publicly traded securities that might be relevant to an investors' decision to trade must be disclosed, positive or negative. This division also interprets the Securities Act of 1933 and other acts that were created in that decade that relate to trading. Any accounting procedures must comply with the generally accepted accounting principles (GAAP). The finance division also determines what companies will be governed under the SEC and assists in registering them.

The Division of Market Regulation establishes, and maintains standards for fair, orderly, and efficient markets. It does this by regulating the major securities market participants: broker-dealer firms; self-regulatory organizations, which include the stock exchanges and the National Association of Securities Dealers, Municipal Securities Rulemaking Board, and clearing agencies; transfer agents; and securities information processors. This division oversees the Securities Investor Protection Corporation, which is an organization that insures the securities and cash in the customer accounts of member brokerage firms against any failure of those firms. The divisions responsibilities include: carrying out the Commission's financial integrity

program for broker-dealers, reviewing and approving any changes or amendments to existing rules of the SEC, establishing rules and interpreting rules on matters related to the operation of securities markets, and the surveillance of markets.

The third division of the SEC is the Division of Investment Management, the sector that oversees and regulates the \$15 trillion investment management industry and administers the securities laws affecting investment companies and investment advisers. This division works to improve disclosure and minimize risk for investors without imposing undue costs on regulated entities. The investment division interprets laws and regulations for the public and SEC inspection and enforcement staff, responds to no-action requests for exemptive relief, reviews investment companies and investment adviser filings, reviews enforcement matters that involve investment companies and/or advisers, and develops new rules and amendments to adapt regulatory structures to new circumstances.

The final division of the SEC is the Division of Enforcement, which investigates violations and suspected violations of securities laws, recommends Commission action when appropriate, and negotiates an appropriate settlement. The SEC possesses civil enforcement authority only, but it works closely with criminal law enforcement agencies when serious crimes are committed. All SEC investigations are conducted privately and extensive research is gathered. In major cases, a team is developed to solely concentrate on a single particular case. There are two kinds of action the SEC can take against violators, civil and administrative action. Civil action involves the SEC filing a complaint with a U.S. District Court describing the crime, the

court issues an order, which can involve audits and other arrangements, and the case is investigated with proper legal action and punishment if the suspect is found guilty. Administrative action proceedings are heard by an administrative law judge; an independent party from the SEC. This judge makes a decision on the guilt of the suspect and is authorized to give just punishment.

The SEC has regulated the stock market for just less than seventy years and has smoothed ripples, prevented volatility, provided structure, and prevented crimes such as fraud. Having a written set of rules has greatly added to the efficiency of the stock market and having such rules has enabled investors to know what actions are suitable and which ones are illegal when trading. Although the SEC has not prevented or corrected every glitch in the stock market, it has prevented many more from even forming. This government entity has structured the stock market and made it a fair and relatively reliable means to invest money. Although the market undergoes glitches under the SEC, the organization prevents many more from forming or occurring.

### **Circuit Breakers**

A device used in the stock market that has proven to be very effective is a circuit breaker. This tool was created after the 1987 crash as a result in the huge drop in value of the stock market. This tool is almost like a cooling off phase, for the market is temporarily shut down while emotions calm and trading slows. This device will eliminate any single day plunges, for once the market crosses a predetermined calculated point, trading will halt for a specific time period.

In the event the Dow Jones declines by 10% on a particular day, the market will close for one hour, anytime before 2:00 p.m. From 2:00 until 2:29, if the market has declined by 10%, trading will cease for a half-an-hour. After 2:30 p.m., if the market has declined 10%, it will not close unless it reaches a 20% drop, then it will close for the rest of the day.

In the event the Dow Jones declines by 20% before 1:00 p.m., a two-hour halt will take place. If this happens between 1:00 and 1:59 p.m., a one-hour halt will occur, and if the market hits the 20% mark after 2:00 p.m., the market will close for the rest of the day.

Anytime the market declines 30% in one day, the market will immediately close for the day. The SEC would closely monitor the market for any foul play in any of these occurrences (Young 171).

The United States stock market has never seen a mid-day circuit breaker. The only time a circuit breaker has taken effect is after the terrorist attacks of 2001. The markets never even opened the day of the attacks and remained closed for almost a week in order for the investing public to calm and renew faith in the economy. The market has lost 10% of its value on a particular day only twice, in 1929 and 1987, before circuit breakers existed. Had circuit breakers been in place during these two crashes, the effects could have been much better, for the markets would not have dropped as much. The Great Depression might have been avoided. Although investors cannot look back and wonder how the 1929 and 1987 crashes might have

been with circuit breakers, they can look forward with some sense of comfort and be assured that such crashes are of the past and are prevented by circuit breakers.

## **Conclusion**

The stock market can be a very profitable way to invest money. In the past decade, the market has experienced an overall boom and grown a great deal in value. There have been good years, and there have been bad years for the market. Overall, there have been many more good years than bad. Money in the stock market is not guaranteed to grow. Success can be plentiful and failure can be painful.

There have been three instances when the painful losses were excruciating. Each time, investors grew a little wiser and a new entity and financial tool were created in the event that another decline looms in the future. There will be large declines to come in the future. Hopefully, the market will possess enough strength and backing to fight off such declines and maintain a healthy investing environment. It is hard to say whether or not the market will experience another surge of growth like it did in the past decade. For us investors, we shall keep our fingers crossed. We will also keep our fingers crossed that we never see our securities plummet and watch our lifesavings slip away. In the end, the market is similar to a game. You win some, and you lose some. Always try to be a winner, but play by the rules. The last piece of advice might quite possibly be the best. Keep your head up when times are uncertain, for there will be better days to come.

## Works Cited

- Bierman, Harold. *The Causes of the 1929 Stock Market Crash*. London: Greenwood Press, 1998.
- Galbraith, John. *The Great Crash 1929*. New York: Time Incorporated, 1961.
- Klein, Maury. *Rainbow's End*. Oxford: Oxford University Press, 2001.
- Klingaman, William. *1929: The Year of the Great Crash*. New York: Harper & Row Publishers, 1989.
- Metz, Tim. *Black Monday*. New York: William Morrow and Company, 1988.
- Miller, Merton. *Financial Innovation and Market Volatility*. Oxford: Blackwell, 1991.
- Rothbard, Murray. *The Great Depression and New Deal Monetary Policy*. San Francisco: Cato Institute, 1980.
- Schroeder, Michael. *Attack Shuts Down U.S. Markets and Causes Global Declines*. Wall Street Journal, September 18, 2001.
- Schroeder, Michael. *U.S. Stock Markets Stay Closed for Third Day*. Wall Street Journal, September 13, 2001.
- Sobel, Robert. *Panic on Wall Street*. New York: Truman Talley Books, 1988.
- Young, Karl. *Calling All Investors: Take a Look at History*. New York: Harcourt Brace & World, 1999.