What do financial folly and religious frenzy have in common? This question has not been carefully explored since Charles Mackay’s spectacular 1852 study, *Extraordinary Popular Delusions and the Madness of Crowds.*

But, in a recent book, William Bernstein, a well-known economic historian, neurologist, and investment manager, makes the connection even more strongly than Mackay. The title of his book, *The Delusions of Crowds,* explicitly pays homage to Mackay’s classic. Bernstein’s delightfully written book is as worthy a read as Mackay’s.

Why investors should care about irrational behavior

Investors should be keenly interested in irrationality – in all aspects of it. Classic finance theory assumes that people are hyperrational, selecting portfolios that are mathematically optimal in their balancing of risk, return, and correlation. From all possible optimal portfolios, they select the one that most closely maximizes their utility, considering their aversion to risk. No one believes this, but the mistakes of millions of investors should cancel out, so that by analyzing markets as if people were rational, you should get a good approximation of reality. Except when you don’t.

Financial markets burgeon with bubbles, crashes, high-priced stocks of companies with no earnings or revenues, and investors who act against their own interest. The recent headlines about GameStop, Bitcoin, Ark Invest, and the use of highly leveraged options by individual investors are reminiscent of the stories told by Mackay and Bernstein. To understand markets, it’s vitally important to figure out what’s going on when prices depart – in either direction – from fundamental value by large amounts.

And I’m not just talking about the stock market. Government bonds are priced in classic Mackay fashion – discounting the hereafter. An Austrian government bond maturing in June 2120, almost 100 years from now, recently sold at a yield of 0.45%. Traders aptly call it the Semper Augustus bond in reference to a beautiful tulip involved in the Dutch tulip mania of 400 years ago. A Semper Augustus tulip bulb briefly cost as much as a house.

Religious frenzies and financial manias

It is timely to look not just at extreme behavior in financial markets but in other spheres of human activity. Bernstein’s choice of religion as the comparable sphere is understandable, although I quarrel with some of the logic and tone. In particular, religion at its worst can be unbelievably destructive: The Thirty Years’ War between Catholics and Protestants in 17th century Europe cost that continent about 20% of its population. Germany lost at least one-third of its citizens. In contrast, financial panics (the usual result of manias) almost always end in recovery and opportunity for investors. While I don’t mean to trivialize losing one’s money, there is a qualitative difference between that and losing one’s life.

Yet there is something out of balance about Bernstein’s demonization of religion. Religion may be based on an illusion of supernatural control over human affairs, but it is still on net a good thing. It evolved because it binds societies together with a common understanding of the world and human nature, and because it sets norms of behavior that are otherwise very difficult to enforce. Moreover, the greatest human need other than mere physical survival is community. Religion creates communities.
that are intermediate in size between families or villages at one end, and the entire human race at the other. While I believe that religion is a human invention, it is an incredibly valuable one if not perverted in some of the ways that Bernstein describes.

**Religious madness: The Anabaptist insanity of 1533-1535**

I start with religion because that is where Bernstein starts and where he places the greatest emphasis, unlike his previous books which are mostly about investing and the historical development of the world economy.\(^5\)

An Anabaptist believes in adult baptism, on the ground that an infant cannot commit consciously to the Christian life; the word comes from the Latin for “second baptism.” This doctrine sounds harmless and much less strange than many religious practices that are widely accepted. Yet, between 1533 and 1535, the “Anabaptist madness” seized northern Germany and let to an orgy of killing, by and of Anabaptists, that Bernstein chronicles in almost too-graphic detail as an iconic example of religious insanity.

What happened? In thrall to an end-times narrative that pops up repeatedly in the history of religion, the Anabaptists expected the world to end. As a portent, citizens of the Westphalian city of Münster reported seeing three suns.\(^6\) The Book of Revelation indicates that, in the end times, a select group will be saved and another, much larger group will be destroyed.

The Anabaptists believed, naturally, that they would be among the select. So did their opponents. In addition, each wanted to do their opponents a favor by converting them, thereby saving them from eternal damnation. Convert or die; that is how religious wars “work.”

If, in our own culture, we have an impression of Anabaptists at all, it’s usually a positive one; the peaceful and quaint Amish of my native Ohio, a subgroup of Anabaptists, are prosperous farmers who seem content to live and let live.\(^7\) In contrast, the Anabaptists of the Münster rebellion were maniacs:

Some lifted themselves up in crazy dances as if about to fly… Some collapsed face down on the ground… some lay in the soft mud, rolling themselves over and over… Some howled with gleaming eyes. Some frothed at the lips. Some made threats while shaking their heads and gnashing their teeth… Some cried, some laughed. We, on the other hand, did not so much laugh at their crazed madness but grieve.

wrote a young German, Hermann von Kerssenbock, quoted by Bernstein.

The Anabaptists also violently took over the city of Münster, prompting a year-long siege that resulted in starvation for the city’s hapless citizens.

What was done to the Anabaptists after the city was taken by the besiegers at least matches what was done by the Anabaptists. The torture and execution of the Anabaptist leaders was unusually cruel, even for the late medieval/early modern culture that inspired *Game of Thrones.*

I tend to think of religious manias, and political ones such as the French Revolution, as being driven ultimately by earthly concerns. These typically include hunger, hatred of those in power, and fear of rapid change, as well as by hope for something better (usually rendered in the afterlife in the religious case, and in an earthly utopia in the political one). People are not necessarily crazy to react to their circumstances by holding extreme views. However, as we have seen, they can become crazy when reinforced through close proximity to a large number of other people sharing those views.

With the benefit of distance, we can laugh at the tulip bubble, internet bubble, and ridiculous pumping-and-dumping of GameStop. We can only shudder at the tale of the first Anabaptists.

**An “electric” example of financial engineering gone wrong**
There is no example of financial irrationality that can match the worst instances of religious irrationality. Financial chaos can lead to death: The suicides of Jesse Livermore, Madoff fraud victim Thierry Magon de La Villehuchet, and 20-year-old Robinhood customer Alexander Kearns were tragic. But most episodes of financial folly are transient and do little lasting damage; the worst ones, such as the crash of 1929, are more enduring but still end in recovery. More typically, the impact of a financial bubble or crash is exaggerated by the lurid stories told by those who were most deeply involved.

Let’s look at one of Bernstein’s examples. Everyone knows about 1929, the dot-com bubble, the crash of 2007-2009, and the recent melt-up in stock prices. Historically minded investors are also aware of tulips, John Law’s Mississippi Company bubble, and the South Sea Bubble. (The South Sea Company had nothing to do with exploiting the riches of the South Pacific; it had the appalling objective of transporting African slaves across the South Atlantic.) Bernstein tantalizes us with just a few bumps in the history of capitalism, preferring to dwell on religious frenzies. But, because to tie the narrative back to investing, I’ll focus on a lesser-known financial episode that he chronicles: the decline and fall of Samuel Insull and his tangle of electric utility companies.

Insull’s biographer Gary Hoover writes,

Few business leaders or entrepreneurs in American history have done more to enable progress and prosperity than Samuel Insull, a name little known today. Yet eighty years ago, he was one of the most famous people in America and Europe – and one of the most despised… He did more to bring electricity to America than any person outside its inventors. Sam Insull put together an energy empire worth billions, only to see it disappear from his grasp in the Great Depression. What happened then is one of the great tragedies of business history.

Associated with Thomas Edison from an early age, the English-born Insull cobbled together a portfolio of electric utilities that baffled the mind. Bernstein describes it: “He stacked hundreds of companies into layers, with the bottom layers sometimes owning pieces of those at the top of the structure.” The layers included “‘superrich cream’ and ‘super-superrich cream’ that came from stacking multiple organizational levels.” Does this sound like a 2008-style mortgage pool? Or is it more like a fund of funds of hedge funds, a so-called f-cubed?

From 1929 to 1932, electric utilities performed like the Dow Industrials: down almost 90%. A company would have to be entirely unleveraged to survive this. But many companies did. Market researcher Michael Painchaud identified stocks that were winners over the brutal 1929-1931 period. There was one electric utility common stock (American Electric Power), three utility preferreds, and a host of familiar industrial names, many of which survive today. But Insull’s conglomerate did not survive. Bernstein recounts:

In April 1932, just three months before the...market...bottomed, his bankers summoned him to a New York office and informed him that they would not support him further. “Does this mean receivership?” he asked. “Yes, Mr. Insull, I’m afraid it does.” The damage to the investing public was immense...by 1946...amount[ing] to $638 million. By that year, the stock market had largely recovered.

Furious investors, opportunistic politicians, and the media ganged up on Insull, who was indicted on dubious charges of fraud and embezzlement. He and his wife quietly fled to Paris. “ALL EUROPE HUNTING INSULL,” screamed the Chicago Daily Tribune. He was extradited to America and placed on trial. Ten days before his 75th birthday, Insull was acquitted. He stood trial two more times on other charges and, again, was acquitted. He died in Paris four years later. Hoover concludes:

Investors who held onto their Insull securities generally turned out okay.... [W]hen the Depression finally ended and stocks rebounded, the total losses on all Insull securities were about 24 percent of the amount invested. None of the companies went bankrupt. The strongest company, Commonwealth Edison, never missed a dividend. Today the company has morphed into Exelon, America’s largest electric company ...[with] revenues exceeding $30 billion per year.

The moral lesson: Even a company that improves society in profound ways, run by a brilliant businessman and generous philanthropist, can ruin some investors if its financial structure, the liability side, is no good. As with most financial disasters, the culprit was leverage. The same tale would be told, with different characters, countless times over the subsequent century.
Bernstein provides entertainment, education, and erudition. Who else could name-drop Abraham, Jesus, the monk Joachim of Fiore (1135-1202), the mathematician Eric Temple Bell, Pythagoras, Francis Bacon, and science writer Michael Shermer in one page (page 38)?

But Bernstein should not equate all religious feeling with its worst examples. If one judges Jews by the most shocking parts of Deuteronomy (many too distasteful to mention here), or Muslims by the political military rather than the spiritual definition of *jihad*, the results are not pretty. One should avoid those inaccurate comparisons that lead to harmful conclusions. That is not how Jews and Muslims conduct themselves.

**Bernstein versus the dispensationalists...and Ronald Reagan**

Yet Bernstein holds a view of “dispensational” Protestant Christians that resembles what we might think of Jews and Muslims who act on the weird exhortations in their ancient texts literally. (A dispensational Christian believes that history and the future are divided into about seven distinct periods, the last one being a 1,000-year reign of Christ on Earth – the Millennium – as promised in the Book of Revelation. This reign will end in “God’s final judgment” and the end of earthly existence. According to this belief system, we are now in the period just before the millennium, which is supposed to end with a “great tribulation,” or time of trouble, before the reign of Christ begins.)

Obviously, we’d want to keep a close watch on political and religious leaders who believe this literally, because we have the technological power to end the world as we know it, and someone might want to hurry the process along.

In this vein, Bernstein tars Ronald Reagan with the dispensationalist brush. There is some evidence that Reagan held those views with varying degrees of seriousness over his lifetime, including when he was president. But the Reagan I remember was a tolerant man and responsible president, owing much more philosophically to William F. Buckley than to any religious figure. While the most extreme of Reagan’s religious beliefs may have spooked secular observers, Reagan the president governed without a hint of them influencing his decisions. He was a very conventional secular conservative.

In a lengthy and detailed study of Reagan’s religious convictions and their influence on his policies, James Green, a British history student and now a barrister, writes:

> Reagan’s rhetoric [has] been labelled “cold war fundamentalism,” comprising an emotional patriotism and portrayal of the conflict in absolute terms. [This] yielded apocalyptic language, and parallels to dispensationalist discourse about foreign policy. However, the symbolic language he deployed did not…define his political behaviour; neither direct military conflict nor a nuclear apocalypse ever came... Indeed, his policies were...more nuanced...than his rousing speeches...; although Reagan did pursue a military build-up in his first term, he later...cultivate[d] more amiable relations with Russia than had existed for decades, including steps towards nuclear disarmament.

Reagan later sought global nuclear disarmament. I wish he had succeeded.

Bernstein’s attack on Reagan weakens his brief against religion. Many people are religious. Most of them are utterly harmless and do good things. Reagan kept his beliefs a private matter, and cooperated effectively with people whose religious views were fundamentally different than his own.

**The red calf**

*The Delusions of Crowds* is worth the purchase price if only for the chapter title Apocalypse Cow. It refers to a holy cow (sorry, couldn’t resist) that was born with an unusual red coloration in Israel in 2018. Some ancient Jews errantly worshiped a golden calf; a few modern ones, plus some Christians, briefly believed that a red one signaled the fulfillment of a Biblical prophecy of the end of days. As always, the end came and went without incident.

Still, the episode forced the question: Are we as gullible as we were 3,500 years ago? I don’t think so; red-cow disease appears to infect only a tiny minority of human beings, and is far less dangerous than the real mad cow disease.

**Concluding thoughts on religion**

The beliefs of evangelical Christians sound wildly fanciful and dangerous when rendered literally, but so do the beliefs of all religions, including my own (Judaism). The story of Abraham and Isaac, the cornerstone of three major world religions representing 55% of the world’s population, is one of the most distasteful in all
of literature. Polytheistic religions are no less fanciful, and more fun to read about – their gods are some bad actors. Behind all this wildness is the necessity of leaders, in trying to bind their people to a religion, to make extreme demands of their followers. That is the only way they can divert the people from going about their business, ignoring religious leaders’ commands to do good or evil.\textsuperscript{13}

And, as all religions start out extreme, they all become more moderate as they adjust to the realities of living in this world – Judaism in the sixth century A.D. and Christianity gradually in the centuries leading up to the Enlightenment. Islam began to modernize in the 19th century, then reversed in the last 50 years. When the Muslim reformation takes place, we’ll say we saw it coming all along.

Contra Bernstein, then, religion is a two-sided coin, inducing good and harm that must be weighed against each other.

Advice for investors

Bernstein writes so skillfully and vividly that he can convince readers of almost anything. I believe that religious nuttiness and financial foolishness are separate phenomena, linked by the fact that human nature is inherently flawed but otherwise quite dissimilar. Neither problem is about to disappear even as we learn more about our psyches.

But financial recklessness is easier for an investor or advisor to avoid than religious folly. If you don’t understand or don’t like the valuation, leverage, or underlying business of a security or fund, don’t buy it.

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2 In a helpful simplification of this method, the capital asset pricing model, or CAPM, says that investors should simply form portfolios out of two assets: (1) the market capitalization-weighted portfolio of all risky securities, that is, an index fund; and (2) cash or some other asset deemed to be riskless.

3 In 1928, economist Max Winkler said the stock market was discounting not only the future but the hereafter. The quote has been repeated endlessly and has been attributed to just about every market sage and wag since that time.


5 Bernstein’s books on the economy are his most valuable, in particular The Birth of Plenty: How the Prosperity of the Modern World was Created (New York: McGraw-Hill, 2004), which was one of the inspirations for my book, Fewer, Richer, Greener: Prospects for Humanity in an Age of Abundance (Hoboken, NJ: Wiley, 2019); and A Splendid Exchange: How Trade Shaped the World (London: Atlantic Books, 2008). Previously, he wrote The Four Pillars of Investing: Lessons for Building a Winning Portfolio (New York: McGraw-Hill Education, 2002), which should be read by all investors. The pillars are theory, history, psychology, and “business” – the last one meaning that brokers and investment managers exist to make a profit.

6 Anyone with a passing knowledge of atmospheric science knows that “sun dogs,” a pair of bright sun-like lights in the sky appearing on each side of the actual Sun at a 22º distance, are an occasional local phenomenon due to refraction by ice crystals. I have seen them myself. So maybe the people of Münster saw three suns. Religious hustlers and other con men have always used rare astronomical or meteorological phenomena, such as eclipses and comets, to persuade others that something supernatural is taking place.

7 Today, there are many other Anabaptist groups in the U.S. and Europe, including the Mennonites and the Church of the Brethren. They number about 4 million and are all peaceful.

8 I’m leaving out examples where the decedent was, or appeared to be, guilty of a major crime.

9 The Great Depression was an economic crisis, not strictly a financial crisis. Historians are still unsure whether a sharp turn-down in the real economy caused the stock market crash of 1929-1932, or the reverse. So I differentiate between the Depression and the market crash.

11 https://www.cnbc.com/id/27404980
