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Drexel Burnham Lambert: A Ten-Year Retrospective

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INTRODUCTION

Drexel Burnham Lambert was the most successful Wall Street firm in the Eighties. They made the most profits in one year of any Wall Street firm-$545.5 million in 1986, a record that stands today.[1] In 1987 their star trader Michael Milken earned a whopping $550 million, a figure that can be compared only to the earnings of titans in 1990's computer industry. Drexel's legacy of sponsorship for new and troubled companies remains an industry model today. They rose from the bottom of the pack to compete with Wall Street's first rank firms. How did they do it? How were they different from other investment banks? Stylistically, Drexel was more aggressive in their approach. Organizationally, the firm experimented. They offered a product that no one else had conceived and that, after it was conceived, competitors were slow to adopt.

GEARED FOR PERFORMANCE

In the 1980s the public was convinced that the leveraged restructuring movement was the work of capitalist fiends. The public and the press were unforgiving in their hostility toward the perceived engine of the takeover movement: the junk bond. Innovative instruments often generate antipathy, and none has generated more than junk. Some argue that the debt instrument itself was the cornerstone of the excess decade. James Brock, author of *Dangerous Pursuits,* writes, "Instead of marking a new development, the junk-bond Eighties represent the last outbreak of a recurrently exhibited, extensively documented propensity for financial lunacy on a massive scale."[2] Many people in modern times still view debt itself as bad, never mind its consequences. Many political and financial conservatives view credit on that scale as too powerful a force. Thus, the rapid growth of the junk bond market to roughly $200 billion in 1988 created a great deal of stress for prudent souls. Junk was called turbo-debt, a license to steal and a scheme that would embarrass even the famous con-artist Charles Ponzi.

[1] Double check this as of 1999
[2] "Junking Corporate America," James Brock, Critical Review

Many acquisitions were financed with junk bonds. But the bonds' role was much less than one might expect from reports. Only 22 percent of the bonds issued during 1980-86 were used for acquisitions and only 3 percent for hostile takeovers. Most of this type of debt (roughly 77 percent of $215 billion) was used for internal investment and expansion by entrepreneurial firms in new and growing industries: cable TV, telecommunications, health care, home building, and others.[3] Companies which successfully used junk bonds include Continental Cablevision, Tele-Communications, Inc. (TCI), Charter Medical Corporation, Hovnanian Enterprises, and others including Stone Container, Worthington Industries, Quanex and Brunswick Corporation.[4]

Until the mid-Eighties, high-yield debt was looked on favorably. In the leveraged buyout (LBO) market, junk debt functioned to reduce size as a critical impediment to takeover. If an investor group had good ideas and a little capital, it could select an undervalued stock and compete with the management for control of the corporate assets. That is what upset the big companies so much—their size no longer insulated them from competition. But once junk bonds were identified in press releases as agents of social turbulence, their luster began to fade. Anyone who had some connection to junk bonds would eventually find his name dragged through the mud. Even sober academic observers were drawn into the storm and accused of prostituting research for the purpose of deceiving innocent buyers.[5] Many people considered the whole market tainted by manipulation and deceitful practices.

The term “junk” is an unfortunate moniker that came about from an offhand comment during a sales discussion in the Seventies. The appropriate terms would be either low-grade or low-rated bond, rather than junk, which has a derisive connotation, or high-yield, which is marketing slang. Even the term non-investment grade bond is slightly biased, since there is a large class of investors who will accept such bonds into investment portfolios. Prior to the 1970s, institutional investors such as insurance companies and pension funds would invest only in bonds with investment-grade ratings

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[3] Glenn Yago, Critical Review

[4] Glenn Yago, *Junk Bonds,* Chapter 6

[5] See Benjamin Stein on Edward Altman, in *License to Steal* and America’s Ethics

from Moody's and Standard and Poor's (S&P). That status was reserved for about 800 corporations (or roughly 564 parent companies and a similar number of subsidiaries that were or could have been rated as investment grade).[6]

Bonds, like bank loans and other forms of debt, are ranked according to their risk characteristics. The highest grade, (using S&P's measures) is AAA, followed by AA, A, and BBB, all of which are investment grades (there are minor gradations in between signified by a plus or a minus). The bonds graded BB and lower (down to C and unrated bonds) are the higher risk "junk" bonds. Within the non-investment grades (including BB+), there are gradations also..

On a daily basis, bonds of different quality are analyzed by their relation to one another. The United States Treasury Security is the anchor security, since market participants consider the likelihood of the Federal Government missing a payment virtually nil. Bond prices are quoted in relation to the Treasury securities. Heavy demand for a security will drive its price up and its corresponding yield down. For example (leaving the math aside), the yield of a $100 bond which pays 5.75% coupon twice a year for eight years and is selling for a price of 95 will yield 0.065 or 6.5%.[7] What if the bond is from a company

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[6] Yago, *Junk Bonds,* pg 21

[7] This yield calculation taken from a popular spreadsheet software application Microsoft Excel 7.0 for Windows 95, Help on "Yield" function

YIELD(settlement, maturity, rate, pr, redemption, frequency, basis)

Settlement	is the security's settlement date, expressed as a serial date number.
Maturity	is the security's maturity date, expressed as a serial date number.
Rate	is the security's annual coupon rate.
Pr	is the security's price per $100 face value.
Redemption	is the security's redemption value per $100 face value.
Frequency	is the number of coupon payments per year. For annual payments, frequency = 1; for semiannual, frequency = 2; for quarterly, frequency = 4.
Basis	is the type of day count basis to use.

A bond has the following terms:

a. February 15, 1991 settlement date
b. November 15, 1999 maturity date
c. 5.75% coupon
d. 95.04287 price
e. $100 redemption value
f. Frequency is semiannual
g. 30/360 basis

which is not investment grade? Perhaps its coupon would be higher, say 10.0%, and its price lower, say 85. Therefore, its yield would be higher: 0.129021 or 12.9%. The bond buyer is demanding a higher yield to compensate for the low quality, high risk of the bond. The yield spread, often called the quality spread, between the two is simply the difference: 12.9 minus 6.5 is 6.4% or .0640. Let us assume that this relationship between the high and low-grade securities is reflective of the entire market. Then we would say that junk bonds are yielding 640 basis points over Treasury (at the eight-year mark).

In very good times, say early 1997, junk bonds were trading at a yield over Treasury of roughly 300 basis points. A lower spread is the mark of trailing confidence (investors perceive a modest difference between investment grade and non investment grade), while a high, wide quality spread reflects trailing apprehension and uncertainty about the general state of companies which issue junk bonds. For example, it was reported in February of 1997 that the bonds of media giant Viacom (grade BB) are very widely traded and are treated as if they were investment grade. That means that Viacom's yield would be at a level above Treasury and its yield spread compared to other junk bonds somewhat narrow (within 200 or even 100 basis points of the Treasury yield). Investors demand that bond income (expressed as a yield) will pay them for the risk they are taking. The more confident they are, the higher bond prices go and the more compressed the quality spreads.

If the yield spread in the overall market went from 640 to 300 one would say that yields are compressed, implying that, should confidence turn, the spreads would uncompress, that is widen. That is what happened from the end of February 1997 to the end of March 1997 when confidence was shaky and yields widened in the overall market from 318 to 345. Junk bond buyers also hope that the price of the bond will appreciate if a company, like Viacom, which issued the bond, improves its ability to meet the payment. A junk bond, unlike a high grade bond, can be upgraded to high grade, and the higher price

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The bond yield is:

YIELD(33284,36479,0.0575,95.04287,100,2,0) equals 0.065 or 6.5%

fetched in the market will reward the investor above and beyond the yield returned to the investor from the time he first bought the bond.

Junk bonds function like commercial loans. A junk bond could be described as a securitized bank loan: a debt that trades like a security in a liquid market. Milken often describes his achievement as the "securitization of business loans."[8] In some ways, a junk bond is more like a preferred stock, which pays a fixed dividend. And investors typically approach junk bonds with an eye to their underlying economic value, which is reflected in the price and yield behavior. Analysis of junk bonds occupy the middle ground between traditional credit analysis ("Can they pay us back?") and value investing ("Will they organize and to maximize value?"). For a typical junk bond, the average life of was fifteen year, and principal payment would come due after ten years.

During the inflationary late 1970s, low-rated companies, mostly small- and medium-size, were dependent on volatile short-term debt financing from commercial banks and on restrictive long-term financing from insurance companies. Floating-rate short-term debt is very rough on a company, since in a recession, rates tend to rise; that is the time which companies need that low cost funding the most. The market turbulence and conservative banker response created a financing problem for low-rated companies, which was filled by high-yield bonds. In fact, throughout the decade of the Eighties, such bonds were used predominately to refinance bank debt. Specifically, from 1983 to 1993, 26.1 percent of the proceeds from junk bonds was higher for refinancing of bank debt and only 14.3 percent were used in connection with LBOs. [9] It was only in the years 1986 to 1989 that LBO activity outpaced such refinancing.

[8] "What to Make of Mike" Fortune 1996______
[9] Martin Fridson , State of the High Yield Bond Market, JACF

Junk Bond Uses

Breakdown of Use Of Proceeds by Percentage of Principal Amount

1983 to 1993

Year	Acq. Finance	Capital Expend.	Future Acqs	General Corporate Purposes	LBO	Recap	Refinance Acquisition Debt	Refinance Bank Debt	Refinance Fixed Income Debt	Second Offering	Stock Repurch	Totals by Year
1983	1.1%	15.9%	0.0%	25.0%	0.0%	0.0%	4.4%	45.1%	6.2%	0.0%	1.9%	100%
1984	2.8%	3.5%	2.2%	22.9%	12.6%	0.0%	5.1%	44.8%	3.8%	0.0%	2.3%	100%
1985	5.9%	0.0%	9.1%	34.9%	3.9%	0.0%	17.3%	22.4%	4.0%	1.3%	1.3%	100%
1986	12.3%	0.0%	1.5%	14.5%	25.1%	1.7%	15.0%	22.4%	6.9%	0.3%	0.5%	100%
1987	7.2%	0.0%	1.8%	7.5%	27.6%	8.8%	22.1%	17.0%	6.3%	0.0%	1.7%	100%
1988	10.9%	0.0%	1.0%	5.9%	29.6%	2.3%	22.1%	22.5%	4.9%	0.9%	0.0%	100%
1989	13.7%	0.0%	0.0%	10.5%	32.7%	5.6%	13.4%	12.0%	11.0%	1.1%	0.0%	100%
1990	0.0%	7.2%	0.0%	1.8%	0.0%	0.0%	64.4%	25.6%	1.1%	0.0%	0.0%	100%
1991	0.0%	0.2%	0.0%	24.9%	3.1%	0.0%	6.5%	17.5%	47.8%	0.0%	0.0%	100%
1992	2.1%	0.0%	1.3%	19.7%	0.3%	7.3%	1.4%	34.6%	31.3%	0.7%	1.3%	100%
1993	2.1%	0.9%	0.7%	21.0%	0.5%	3.2%	4.7%	31.5%	34.8%	0.2%	0.3%	100%
'83 to '93	**6.3%**	**0.9%**	**1.5%**	**16.7%**	**14.3%**	**3.8%**	**11.5%**	**26.1%**	**17.6%**	**0.5%**	**0.8%**	100%

Sources: Securities Data Company, Merrill Lynch High Yield Research

THE FINANCIER

The discoverer of the great potential of these securities was Michael Milken. No story of the rise of the junk bond market is complete without his story.[10]

Michael Milken was born in Los Angeles, California on the 4th of July 1946 to Bernard and Fern Milken. He grew up Encino, California with a brother, Lowell, 2 years younger and a sister, Joni, 12 years younger. Michael enjoyed a very pleasant middle class childhood in the San Fernando Valley. He was extremely bright, with a prodigious memory and a very competitive spirit. While less athletic than his brother, he exhibited a leadership charisma very early in life. Some called him a boy wonder.

Milken was very popular with the girls by age eleven, owing to his ballroom dancing skills and his genuine, attentive charm. By high school he was throwing himself into everything: student council, basketball, track, Boys' League, debate tournaments, Pep club and other activities. He was voted "most spirited" and "friendliest" class member in the class of 1964, at which time he was also crowned prom king. Lori Ann Hackel, his high school sweetheart, was school princess and voted "most likely to succeed." She later became his wife. An important theme in Milken's life was the transformation of adversity into opportunity. Consider that Milken became a cheerleader. In high school, he stopped growing and was not tall enough to continue in basketball. He joined the cheerleading squad, creating controversy at times, for example, by leading vigorous cheers when his team was ahead 42 to nothing.

Some interpreters, in particular Jesse Kornbluth in *Highly Confident,* argue that from a very early age Milken was a "too eager-to-please." But this really goes too far. Milken, no doubt, works hard to assure that those who come in contact with him leave with a good impression. His sales skills are, after all, legendary, and even his critics acknowledged that Milken's power and success never impaired him as a salesman.[11] His

[10] Much of the following detail is from Fenton Bailey's *Fall From Grace* and Roy Smith's *The Money Wars* unless other wise noted.

[11] Bruck, page 55

mental rigor consistently impressed clients. A more obvious pattern of behavior (without relying on questionable psychological assertions) is Milken's breathtaking optimism. He maintained exhilaration through intense periods of business, social and legal pressure. Milken seems to a profoundly determined individual with dynamic sales skills. A simpler explanation than the one offered in *Highly Confident* is that the virtues Milken exhibited as a youngster were authentic, pleasantly out-of-step with today's standards of juvenile virtue.

In 1965, the Watts riots of Los Angeles had a profound affect on Milken's thinking. He concluded from that episode that the opportunity to fail and to succeed is critical to the development of economic skills. Thus he began a lifelong interest in the problems of "human capital." He switched his direction from mathematics and science to business. The process of channeling capital to ability—ability at all economic strata—he called the democratization of capital.

After graduating high school he attended University of California at Berkeley as a business major during the mid- to late sixties. There, he did not take drugs, smoke or drink. He avoided even soft drinks and carbonated beverages. The Berkeley spirit of overhauling the world aligned with his own worldview. In an op-editorial written at age 24 in 1970, which he submitted to (and was rejected by) the *New York Times* he said, "Unlike other crusaders from Berkeley, I have chosen Wall Street as my battleground for improving society because it is here that governments, institutions and industries are financed."

Michael finished Berkeley and enrolled in Wharton Business School in Philadelphia, specializing in finance, information systems and operational research. Several professors singled him out as the brightest student they had ever taught. But that level of achievement did not come effortlessly. A fellow student reported that Milken studied very hard, often secretly and late at night. He had a quick mind, he was prepared, and he was interested in being number one.

In January of 1969, on the recommendation of a professor, Milken started part time as an operations consultant to the chairman of Drexel Harriman Ripley, a fading investment bank. Securities delivery was a major problem in the industry at the time. One executive describes Milken's arrival at Drexel as a bull in a china shop. Nevertheless, he organized the overnight delivery of securities, saving the company a half a million dollars annually.[12]

In 1970 Milken went to work full time, for Drexel (now Drexel Firestone) in Philadelphia and then in New York. Drexel, in searching for a partner, had received a cash infusion from Firestone Tire and Rubber Company. It was thought by some at Drexel that Milken didn't have the personality to make it in the business. Milken was out of place stylistically, socially and culturally. Other employees were educated in private schools, Milken had come from public schools. Milken was teased for his dress sense, for being "no stranger to polyester." Even later in the Eighties, after Milken was proven successful, writers pointed out that he continued to buy shirts off the rack when most of his peers in the investment banking world purchased tailored shirts. And Drexel was the bluest of the blue blood East Coast, Protestant firms, while Milken was Jewish.

Before Milken had an opportunity to put his investment ideas into practice, he changed the basic organization of the firm. As operations analyst, he surveyed the various business units and found a hierarchy topped by sales, then by traders in the middle, then researchers on the bottom. He also noted that sales people received 80 calls for every 20 they made, suggesting a certain amount of passivity. Buyers for products existed, but sales staff was inadequate to develop and distribute new products. Only research could create a broader market. Thus, over time, research came to dominate the organizational order. [Point here?]

Others in the firm shunned Milken's investment policies. He took an interest in investments that had fallen on hard times, such as convertible bonds, preferred stock, and real estate investment trusts. To Milken, these were buying opportunities, since the

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[12] Connie Bruck, page 25-26. George Gilder's figure is $500,000 (a one time savings). Bailey's *Fall From Grace* says

underlying assets were unchanged. Certain bonds that had fallen into disrepute by losing their investment grade rating were also undervalued, in Milken' eyes, again because the companies behind them possess assets (factories, machines or properties) sufficient to generate earnings. Milken's extensive studies uncovered such values and he made the company a fortune.

But his approach appeared too speculative for a firm that historically preferred blue chip companies. Drexel still saw itself as a snooty firm fostering relationships with the Fortune 500 companies and few others. Sales people were upset that researchers were contacting customers directly. There was much grumbling about Milken, despite his apparent successes early on. They did not like the way he looked or the products he invested in, and Milken never responded directly to these insults. However, by 1973, his frustration led him to consider leaving the firm to teach at Wharton. And from 1974 to 1976, he participated in Wharton's simulation model projects.

In the end, Milken stayed and in 1973, Drexel merged with Burnham and company. Milken's salary formula was devised at a base salary and a dollar for every two dollars he made for the firm. That compensation formula never changed. Starting with a trading account of $2 million, he doubled his money in the first year, trading in securities that no one else would touch. By 1976, at 30 years old, he made $5 million in income. According to author Roy Smith, that amount, if reported at the time, would have shocked Wall Street.[13]

Milken first at Berkeley in 1965 and then at Wharton studied the work of many financial scholars. In particular, W. Braddock Hickman's work in the late 1940s and 1950s suggested to Milken that the higher risk of default on low grade bonds was compensated by the higher interest that they paid. The market overestimated the cost of companies failing to meet payments on their obligations. Thus bond prices were too low and the quality yield spreads correspondingly too high. If fewer bonds actually defaulted than were expected to default, then a diversified portfolio comprising such bonds would

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the project saved millions annually.

outperform a portfolio of investment-grade bonds. The low grade bond market consisted of "fallen angels": bonds that had been listed as investment grade but had been downgraded. Milken created a market for investors who sought higher risks and higher returns; hence, the "high-yield" bond.

The fallen angels, in the early to mid-Nineties, represented about one out of five junk bonds. Some who have studied the junk bond market—no one else studied the history of the fallen-angels until 1991—contend that there is no basis for new investment insights from a proper reading of the data that Milken looked at. Though there might be some argument about the ancestry of junk bonds, there is none about their success.[14] Even if Milken completely misread the history of bond price data—which is highly unlikely—the use of high-yield security in new investment contexts would still today be a viable and important innovation. (Technically, the use of junk bonds in various contexts such as the leveraged buyout is the innovative technique and the market for such bonds, tying buyers to customers, was an innovation. The bond itself was not an innovation since low-grade bonds had been present for years.)

Many of the criticisms of junk bonds that appeared in the media did not consider how to appropriately judge a financial innovation. For example, some companies which issued bonds failed, some buyers of junk bonds were crooks, and some mutual funds that bought junk bonds did not perform well. But the same can be said of common stocks at one time or another. The success of the junk bond market is independent of the circumstances of the original issuers, underwriters, buyers, sellers, and holders of junk bonds. The success of the junk bond market is not dependent on the particular successes of individual companies which issue junk bonds, the investment strategies of money managers who trade junk bonds, or the institutions which buy, sell and hold junk bonds. The junk bond market cannot be impugned by reference to a particular company or strategy that failed. Like the common stock market, it cannot be judged as a failure or success by its association with a strategy, a company, a market crash or a person. Like the LBO, it

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[13] Roy Smith, *Money Wars*, page 231
[14] Edward Altman, FMA seminar 1993, in answer to question from audience. See also Fridson, Fallen Angels and the Rec'd Wisdom, Financial Analysts Journal, MarApr 1993

should be judged by how it functions to achieve a purpose. For a new company, junk bonds are a source of capital for expansion. In a leveraged buyout, junk debt serves to more precisely partition the risk by earmarking companies' earnings among the different classes of security holders. Milken was the first market maker in junk bonds that allowed these purposes to be fulfilled. In Milken and Drexel's absence, other investment banks and dealers make the market.

In 1978, due to health problems in his family, particularly his father's cancer, Milken decided to move his entire department of 30 people to Beverly Hills. A huge X-shape trading desk dominated the trading floor that he designed. There he could sit at the middle to see and hear everything that was going on. Under Milken's stewardship, Drexel was one of the first firms to computerize calculations and make available on line the complex yields and cash flows of the varied forms of securities.[15] In 1980, it was novel for sales people to be able to view both the basic information (the name, issue, and rating) of the security and to calculate on line the price of a security with various features such as a call option or a put option, a warrant, a refund schedule, and so forth. Most of Wall Street was still using cumbersome calculators for these complex formulas.

The trading system was a minicomputer, a Prime 550 Model 2, connecting 250 Televideo terminals by serial communication ports to a shared database (FORTRAN). The database contained the trading history of all Drexel customers, roughly 1,700 high yield securities and 8,000 securities in the public bond market. A former systems analyst at Prime named William Haloc worked for Drexel to develop the system to allow for instant calculation. A member of Milken's team could call up the customer's history, the amount of his potential profits or losses, his ability to buy new issues and investment philosophy. With such detailed knowledge of the buyers and sellers, Milken "made the market" in junk bonds. Such instantly available information allowed a market to be made where there had been none before, defying the conventional wisdom about the liquidity and marketability about non-investment grade securities. Most of Wall Street was earning money from the risks inherent in stock investing. Drexel alone served customers demand

[15] Gilder ASAP

by selling products that earned money from the risks of debt. Thus, it was not technology alone, of course, but Milken's insights and sales techniques aided by the new technology which started the market.

Amazingly, Milken had planned this as early as February 1971. In a letter to the Drexel Firestone salesmen, Milken said it was Drexel's intention to take large positions in speculative bonds to provide liquidity to the marketplace so institutions would feel comfortable investing there. Further, it said that Drexel would create a computerized system for matching buy and sell order in lots of 500 bonds or more and that Drexel would provide detailed, reliable statistics on the market.[16] At that time in the early Seventies, there were many financial firms (200?) each making the market in about 50 securities. Drexel research broadened the coverage, allowing them to make a market of 500 securities, mostly fallen angels. That gave them the edge. Drexel was able to use that newly created liquidity to serve hungry buyers.

Buyers of the new Drexel product included mutual funds. High-performance funds were always looking for ways to increase their returns, so there was a natural customer base. Massachusetts Mutual, Keystone, Lord Abbott and First Investor's Fund for Income all became and remained purchasers of the new high yield securities throughout the Eighties.

A loyal customer base sustained the junk bond market in its early days. Another set of buyers was insurers. These companies depended on their investment income and some of the less established companies naturally wanted to increase their yields to compete with the dominant players. These buyers included Saul Steinberg, who owned Reliance Insurance, Fred Carr who owned Executive Life (First Executive Corp.) and Larry Tisch and Meshulam Riklis, both of whom owned insurance companies.[17] These investors were outside the Wall Street mainstream, which had its own syndicates of buyers for debt products. Drexel created a new pool of buyers—some of them considered unsavory by Wall Street's traditional lights—to get around the loan placement hierarchy. In the early days, Drexel was a bottom-tier firm that could not participate in the best and most

[16] My Story, Forbes

profitable deals sponsored by the top tier investment banks, such as Salomon Brothers, Goldman Sachs and Morgan Stanley.

Milken was not yet underwriting junk bonds, merely trading them. Demand for the bonds picked up over time as new money sought the potential high returns suggested by the very good actual past performance. Another investment bank, Lehman Brothers Kuhn Loeb, was experimenting with their troubled clients, devising ways of allowing their client companies to originate debt.[18] Milken, trading in that debt, reasoned that Drexel could participate in such origination. He suggested to Frederick Joseph, head of the Corporate Finance department at Drexel in New York, that the company seek clients and underwrite debt. That is, find non-investment grade companies which have been shunned by the larger firms, and let Drexel raise money for them. In April 1977, the first Drexel underwritten junk bond issue was Texas International. By the end of 1978, Drexel was the number one issuer and would never be overtaken.[19]

Milken opened the bond market wide to firms that had never had investment-grade ratings. The innovation was the tight linkage Milken created between the issuers of debt and the buyers. Many companies could not get money at any cost, and high yield bond buyers placed a vast new network of funds—even international funds—within their reach for the first time. Over the next decade, Milken raised funds for more than one thousand such companies, including MCI, Ted Turner's CNN, McCaw Cellular, and many others. And he continued to assist firms which had fallen out of favor, raising money for Lorimar in 1979, Warner Communications (now Time Warner) in 1984, and Chrysler in 1984 when no one else would touch the auto company.[20] American Motors (year?) and Mattel (year?) were also resuscitated with high yield finance. By 1982 and 1983, Drexel was the major underwriter of debt in the country and of all industrial companies.

The contribution of financing techniques to economic development is not subject to many disputes any more. Dynamic medium-size and smaller companies created the surge in

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[17] Roy Smith, *Money Wars*, page 225 -226
[18] Bruck, page 44
[19] Bruck page 47-48

employment during the long economic expansion of the Eighties. From 1980 to 1986, firms using high-yield debt accounted for 82 percent of the average annual job growth at public companies. They added jobs at six times the average rate in each industry.[21] The Fortune 500 companies did not add new jobs (on net) during the decade, and have consistently over the last several decades held 17 percent of jobs in the country.[22] It is the small and medium sized businesses that have the deserved reputation for new jobs in new industries. From an early record of success (roughly 1978 to 1985), in particular the association with growth and job creation, junk bonds had a favorable connotation, akin to venture capital or startup capital. Of course, there is no perfect size or distribution of company sizes. The key to organizational flexibility is financial flexibility. And in many instances in the 80s, junk bonds provided the flexibility to execute important and necessary business strategies.

Milken's fabulous success became Drexel's earning power even before the junk bond market got huge. Milken in real terms took over the company that nominally employed him. Junk bond financing evolved quickly. In 1981, Drexel took a daring new step, issuing bonds for leveraged buyouts. By 1983, Drexel mad a more daring and fateful decision to provide junk bond financing for hostile takeovers, or leveraged buyouts taken against incumbent directors' will. Drexel, primarily the East Coast corporate office, aggressively sought out customers like other investment banks, but often the raiders such as T. Boone Pickens came directly to the firms. It should be noted that Milken has always stressed difference and the separation of hostile takeovers and the junk bond market that he created as financing vehicle for midsize companies. He saw that takeovers against the owners would have negative political repercussion on the kind of market that he had created. Apparently, one of two things happened: either Fred Joseph, as the ambitious and confident head of Drexel, thought he could handle the political reaction to hostile takeovers, thus overruling Milken's objections, or, Milken's objections were made too modestly, and he acquiesced Drexel's participation in a controversial market. Milken did

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[20] R. Smith pag 233,
[21] Yago, *Junk Bonds*
[22] Better source? "Job Growth, Prevailing Wisdom On Downsizing Challenged By Conference Board Chief", BNA's Employment Relations Weekly. Bureau of National Affairs, Inc. Washington, D.C., Volume 14 Number 18 May 6, 1996, http://www.bna.com/newsstand/ber/3686_466.htm

not think hostile takeovers were bad, but that the reaction to them could be damaging. (Later in November of 1986 and again in 1988 he repeated his objections, but was overruled by corporate finance.) Casting reservation aside, Milken began to arrange "war chests" in 1984 for willing and able corporate raiders who were likely to succeed and who could propel Drexel into the top of the mergers and acquisitions field. By March 1985, Drexel completed its first junk bond-financed hostile takeover.[23]

In the sixties, a “Saturday Night Special” referred to a small, cheap handgun that was used for impulsive criminal acts. This gruesome image was conferred on a type of corporate control transaction (a Sixties takeover) where an aggressive conglomerate bought a small company. Over a weekend, it was possible for a deal to be made and new owners in place by Monday morning. The power and abruptness were startling to people. Typically, a larger company would make an offer directly to shareholders of the target company at a 15 to 25 percent premium over the existing share price. Sometimes the offer would be for only 51% of the shares, and if a shareholder wanted the cash, he needed to get in early. The remaining holders of 49% would have to take what the new owners wanted to give them, usually less desirable securities. The deal would be launched to expire in 14 days. The board of the target company could start to defend its management practices, in part by taking out big newspaper ads denouncing the “raider.” But the game was almost over by then, since big blocks of stock were already in friendly (seller) hands willing to accept the buyer’s offer. It happened very quickly. The legislative response was the Williams Act of 1968 that restricted this type of takeover in the name of leveling the playing field for the benefit of targeted managers.

By the early Eighties, Milken and Drexel’s Corporate Finance department had enabled raiders to contest for companies, reinvigorating the market for corporate control. But this time with a twist: the aggressive raiders could be a very small firm using borrowed money. Milken would arrange some seed money for a raider to provide an initial stake. Then the funding would be promised by a syndicate of buyers who committed to buying the debt (or that part of the debt not provided by banks). Drexel could then announce that

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[23] Bruck, page 13

it had the money to back the raid, though no one had actually put up the money. Drexel issued a form of guarantee or credit: a letter stating that Drexel was "highly confident" that the money borrowed for the purchase of stock could be placed among buyers. That letter was enough to get the banks and other players involved. And like the Saturday Night Special, deals could be "two-tiered" takeovers, meaning the initial wave of cooperative sellers of shares would get cash, and the remainder would receive securities, namely, junk bonds.[24]

Milken raised $1.5 billion in 48 hours for Carl Icahn's offer for Phillips Petroleum.[25] From 1985 to 1990, hostile takeover financial transactions tallied $140 billion. The number of hostile takeovers peaked at 46 in 1988, declining to 2 in 1991.[26] As noted earlier, the public misperception of leveraged hostile takeovers was inevitable following the journalistic focus on "bust-ups". Largely ignored in public discussion was the rational foundation for offering managers higher pay for better performance and eliminating cross-subsidies in the conglomerates broken-up. It should be noted that junk bonds were never the primary source of takeover funding.[27] Internally generated funds of the target company and bank debt were the larger components of the funding packages used to purchase a company. Junk bonds, however, were the essential funding element because that part of the funding had always proved difficult.

Unfortunately, as often happens on Wall Street, and elsewhere, the innovation of a genius is misapplied by the ineptitude of his imitators. And so it was with junk bond financing. In the early Eighties, Wall Street had come to look on junk bonds favorably as an important source of funds for middle-market companies, either new entrepreneurial companies or older firms which need new funding to change their ways of doing business. Roughly three quarters of the junk bonds were used for such non-controversial purposes.[28] In the mid-Eighties, junk bonds began to be used for LBOs in loud and public contests between the famous takeover artists and the companies they targeted for

[24] See Easterbrook and Fischel, page 180
[25] Bruck, page 19
[26] *The Economist*, Survey on Corporate Governance
[27] Glenn Yago, Junk Bonds, page 8
[28] Toffler, Power Shift, page 48. Better source?

purchase. By the late Eighties, the market had grown tremendously, thinning the potential profits and limiting buyout opportunities. Furthermore high-yield debt was being used by big companies to structure their balance sheets in the way outside competitors were promising to do. In this last stage, internal management was leveraging the corporation as a defense against outside managers. The insiders took on debt [the defensive MBOs described…where?), but without the vision of the competitors and, most crucially, without aligning the interests of the managers with the fortunes of the company.

Those who engaged in misguided buyouts used the form of the LBO but without fully understanding its function though some simply did not recognize the signs of a higher risk market. In response, the reputation of the market Milken had created suffered. Milken himself was quoted publicly as saying that it was time to de-leverage, time to stop raising money by borrowing and consider other means. As he later recalled "After 1986 I felt like a skilled surgeon who's been locked out of the operating room and watches through the glass in horror as some first-year medical student go to work on a patient. They're cutting him open while referring to the textbooks, but they're turned to the wrong chapter. I keep pounding on the glass and crying, 'No, no, no.'"[29]

True to his form as financial engineer, not merely the "junk bond king," Milken said that the best deal of 1989 was the buyout of United Air Lines-because it did not go through. By the end of the Eighties, stock prices were very high by historical standards. However, Wall Street kept structuring deals that didn't make sense at such high stock prices. According to Milken, "It's okay to leverage to buy underpaid [sic—*undervalued*] assets. It isn't okay to leverage to buy overvalued assets, particularly when the cost of capital is in double digits. Prices had gotten so high in the late 1980s that the winning bidder was often a loser."[30]

Many people have questioned whether Milken's concern for companies was genuine. Was he driven by lust for power or by powerful ideas? We know that he had developed a deep understanding of the new financial theories that prompted his own discoveries. His

[29] My Story, Forbes, page 80

drive to understand surely suggests that he was propelled by long range goals rather than fueled by short-range opportunities. While at Drexel, Milken focused devotionally on individual companies. He publicly rejected the label of "junk bond king" and his efforts were directed toward dynamic capital restructuring to meet conditions in the market. Milken in large part implemented his own financial theory that there is no persistent structure—no fixed composition of debt and equity—that can work for a given company. Capital structure does matter because the world changes and presents opportunities that require the dynamic daily reorganization of capital.

Modigliani-Miller had emphasized the hyper-efficiency of markets, the inability of entrepreneurs to find any opportunity in a super-smart world, and even the indistinguishability of luck and skill. Milken contradicted this. There are inefficiencies and opportunities that arise if one can recognize broad social trends in a rapidly changing world. The core value of a company can be enhanced by responding to the changes in taxes, ownership structures and business prospects, including the changing possibilities of failure. Having a core of managers who owned part of the company was key to developing that value. As a financial engineer, he implemented theories of modern finance by using all kind of instruments, not just junk bonds.[31] The paper he wrote with one of his professors after he left Wharton was "Managing the Corporate Financial Structure" which examined ways of optimizing investor returns by modifying a company's capital structure.[32] Companies, "…should vary the capital structure as their businesses change and markets prefer debt or equity, or as interest rates fluctuate."[33] Such engineering functioned in a way that most people, including many people on Wall Street, did not take time to understand. They maintained prejudices about the function of debt and could not even bring themselves to recognize the value created or attribute the accomplishment to a man with a vision. Milken's achievement was grounded in novel thinking about the nature of companies.

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[30] My Story, Forbes
[31] Peter Bernstin, Capital Ideas, page 178
[32] Bruck, page 99
[33] My Story, Forbes

As to his personal motives, his enthusiasm for his client companies surpassed that of other investment banks. The plight of smaller companies was, in Milken's mind, a cause with an ethical foundation. The way those banks and rating agencies treated smaller companies, he remarked, was "discriminatory." Many of clients of Milken were like associates in the cause. Reginald Lewis of Beatrice, William McGowan of MCI, Ted Turner of CNN, and Henry Kravis of KKR shared a distaste of existing corporate leadership and were very anti-establishment in temperament.[34] Milken's enthusiasm for the cause carried over into his coworkers and clients. Milken's credo was that there is no failure, no distress, only opportunity. "[B]ankruptcy isn't an end. It's a opportunity to build a more suitable financial structure."[35] Recall, for a moment, the basketball player who stopped growing and became a cheerleader instead.

Milken's ebullience can be described fairly as bordering on missionary zeal. But unlike others in this class, he did his homework. He believed in himself and his cause. He thinks of himself as a social scientist. "Wealth is a by-product of solving problems and creating value. If you do those things, you get a high rate of return. If you don't solve problems and create value with your investments, you lose money.... The best investor is a good social scientist."[36] What he means here is that he has an understanding of broad social trends and has a grasp of the potential impact of various scientific and technological breakthroughs. His success in the cable television industry is an example. "A decade ago [1982] we could see that while TV networks and their affiliates were the blue chips, cable was the future. Cable was junk from an investment ratings point of view. In 1981, 1982, 1983, at the Drexel conferences, I would get up and say NBC, CBS, and ABC are left at the post. The networks were providing broad entertainment. Mass audiences. There was a parallel earlier when we had this explosion of special-interest magazines that put the big, broad mass magazines like Look and the old Life and the Saturday Evening Post nearly out of business. The same thing was inevitable in TV. Cable would eventually be able to provide 50 channels – 50 special-interest broadcasts instead of one mass broadcast. People can watch sports when they want to watch sports, news when they want news,

[34] Abolafia page 158-160
[35] My Story, Forbes
[36] Forbes interview, pg 95

movies when they want movies, not when the network wants them to. But from a borrower's point of view, cable was junk and network TV was blue chip. Network had a record. Cable didn't. People forget that today's junk is often tomorrow's blue chip."[37]

Milken can be described as a futurist, someone with grand visions of mankind's destiny.[38]Some of his visions don't sit well with his supporters. For instance, in an interview in Forbes magazine in 1992, editor James W. Michaels takes Milken to task for what he thinks are some self-flattering and pretentious statements. The works of best-selling author John Naisbitt (*Megatrends,* 1982 and *Re-inventing the Corporation,* 1986*)* has influenced Milken*.*[39] Thus, he is loosely associated in style and purpose with other inspirational optimists such as authors Alvin and Heidi Toffler (of the huge bestsellers *Future Shock* 1970, *The Third Wave* 1980, *Power Shift* YEAR??? *)* and conservative economist and founder of the Discovery Institute George Gilder (*Microcosm* 1989 and *Telecosm* 1996*)*.[40] The difference is that Milken brings to his futurism not an author's air of prognostication, but a financial entrepreneur's can-do spirit.

Milken was out of the market by 1990. The New York Times that year declared the junk bond business near dead: "While there will always be a stock market, the need for a junk bond market is far less obvious…It is unlikely that there will soon be a sizable market for new issues even of relatively high-quality junk."[41] It was not until 1993 that the junk-bond market volume returned to normal and surpassed its previous high of $200 billion in 1989.[42] Following regulatory constraints and a credit crunch in 1990 and 1991, the volume declined significantly in 1992 to $168 billion before picking up again. By that time the market had come to resemble its pre-adolescence in the early Eighties, providing

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[37] My Story, Forbes
[38] Bruck discusses this in several places. See also Jesse Kronbluth and William Taylor.
[39] Yago, page 26
[40] Here is a quote from Alvin Toffler which sounds like it could have come from Milken: "In organizations with traditional bureaucracies, that synthesizing and selecting function was served or carried out by the middle management, collecting information from several departments, synthesizing it, and then either moving it up the hierarchy or sitting on it and refusing to send it up. What has happened is the introduction of computer technology into business; it has wiped out large swatches of the middle management, because it's no longer necessary. But what makes it possible to do away with all those intermediaries are information systems that permit the individual at the bottom of the hierarchy to cross into other departments and other cubby holes containing information almost at will." Source is the Progress and Freedom Foundation website, http://www.heritage.org/pff/amciv/ac-july/ac795fs.html. .
[41] Riva Atlas, Institutional Investor, page 55
[42] Figures are par values outstanding.

internal finance for mostly medium-size and smaller companies.[43] The first quarter of 1995 saw another peak in mergers and acquisition activity. The $73.2 billion of transactions that quarter was not geared toward replacing inefficient management but to achieving market share and economies of scope and scale in media, communications and entertainment.[44] Junk bond issuance increased to $73 billion in 1996.[45] That same year, high yield mutual funds took in a record $12.3 billion from the yield hungry investing public. The previous record of $9.6 billion in 1986 had stood for a decade.[46]

THE ACHIEVERS

There was a phenomenal quantity of vitriol aimed toward Milken and Drexel. That is the subject of another paper. Here the focus is on the breaking down the positive elements of Drexel's success and breaking down the achievement into understandably small pieces.

Clearly, in the big picture, Milken was a social revolutionary with a constructive, not destructive, edge. There was never bad news, and every action was an opportunity. What characterized Drexel, according to Milken, was the client service, a "…commitment to helping people—being there when they need you." How intense was the drive to succeed? Robert E. Linton, chairman of Drexel, offered a psychological explanation that, "Michael wants to win the game. Michael wants to have it all. Michael wants to do every piece of business and every deal and make every dollar."[47] How did this motive force take shape and achieve the tremendous advantage over competitors?

One money manager who visited Milken in the late seventies remarked about him, "He had the issuers. He had the buyers. He had the most trading capital of any firm. He had the know-how. He had the best incentive system for his people. He had the history of data—he knew the companies, he knew their trading prices, probably their trading prices

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[43] Martin Fridson , State of the High Yield Bond Market, year???
[44] Macey and Miller, Corporate Governance, page 102
[45] Atlas, Institutional Investor, page 55
[46] New York Times, January 29, 1997, page C2.
[47] Quoted in Robert Alcaly, New York Review

going back to at least 1971. He had boxed the compass."[48] And in a portrait of Milken from *Institutional Investor* in 1986, one investment banker said, "Mike is the only person in the securities business today who can do it all. He is a master trader, salesman, deal structurer, credit analyst, merger tactician, securities venturer. And he does these things at the level of the best guy in each of these categories. You look at the difficulty *firms* have in putting all these together—and here you have *one man* embodying all these attributes." [49]

Drexel possessed an array of unique qualities, capabilities, techniques and organizational approaches. Milken, more than any other individual, was the engine of Drexel. He served several different functions: early, as a reorganizer of Drexel Harriman Ripley, later as top notch researcher, credit analyst, and computer systems proponent, and finally as advisor to issuers of bonds, as key market- making trader of the bonds, as manager of the Drexel participation, and as a manager of compensation and incentives. The following points are offered as a conceptual schema, and they are explained in greater detail below. Drexel Burnham Lambert with Michael Milken:

1. **discovered the investment potential of an out of favor instrument**
2. **made the market in that instrument**
3. **opened capital to a new range of businesses including those with intangible assets**
4. **developed confidence in the market by effectively securing commitments to fund**
5. **developed alternate sources of funds outside traditional Wall Street**
6. **promoted a new investment concept to investors**
7. **altered the competitive environment in the market for corporate control**
8. **could conceal the identities of raiders and their source of funds from potential target companies**
9. **could adjust the quantity of funds offered to market to meet the rising demands of the investors**
10. **could use its own capital to finance its deals**
11. **could participate in a deal as the most versatile participant vis-à-vis all other participants to the deal**
12. **could reduce conflicts in the event of trouble by their unique financing methods**
13. **could control risk better by the matching of customers to clients**
14. **could control risk through diversification by means of trading in and out of their dealer portfolio**

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[48] Bruck, page 57
[49] Bruck, page 307

15. could extend the life of troubled companies by creative refinancing

1. The **junk bond** was an instrument that was frowned on. No other investment bank was buying or selling junk bonds on a large scale or even attempted to enter this market until Drexel became a hugely successful and competitive force. Milken at Drexel served over 1,500 companies by raising $93 billion of a market that had grown to $200 billion overall (roughly 1977 to 1989).[50] That means that he achieved a market presence nearly as great as all his competitors combined.

2. Milken **made the market** in junk bonds. Milken made it easy to buy and sell these securities. The money he made can be measured in one way by recognizing the basic spread he captured between the buyers and sellers (the bid-ask spread). Investment grade corporate and US Treasury securities are quoted to buyers and sellers with very small bid-ask spreads. The margins between buy and sell are very thin, quoted in hundredth of percentage points (basis points), reflecting the presence of a large number of competitors and large volume transactions. Milken, in this new market, had very large margins, 2 to 3 percentage points, reflecting both his unique knowledge and the fact that competitors waited long before entering the market. Eventually, the interest rate spreads that Milken captured were cut down when competitors entered the scene. The money that Milken earned for Drexel was roughly half from trading and half from fees.[51]

Milken also added value in the form of liquidity. The effect of pooling junk bonds was similar to the effect of pooling home mortgage into mortgage-backed securities (MBS). What was the liquidity worth in the junk bond market? Considerably more than in MBS market. While home buyers benefited from a reductions of 35 to 50 basis points (a third to a half of 1% interest), entrepreneurs saved probably around 2% interest difference by raising capital with junk bonds rather than going to banks. This is only a rough estimate of the benefits, since some of these companies often couldn't get loans from banks at any price. Drexel's domination meant that no other investment bank did as much for so many though there were many good individual deals conducted by banks other than Drexel.

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[50] Yago, JB, page 25

The other factor which made this market so robust was that the buyers of junk bonds were essentially a new group of fixed-income bond buyers with an appetite for a hybrid risk: equity-level returns with bond risk. Put another way: upside potential with downside protection. Institutionally, professional bond buyers were very conservative, averse to changes in the risk of debt. And Wall Street brokerages focused on selling stocks to the public and institutions with appetites for risky equity. Making money on the changes in risk of debt was a new idea, and there was a segment of the investment market that wanted such bonds if they were sufficiently liquid and the companies supported. Milken raised money quickly by using an instrument which bypassed the stock securities registration requirements (which took time) and which could be sold to bond buyers (pensions, insurance companies, S&Ls) who were more aggressive than traditional bond investors.

According to Milken, "[I]f Drexel was supporting a security, people would invest in it, because they knew they could get information and that we would make a market. We wouldn't just bring it out and walk away."[52] Other investment banks were known for, on occasion, peddling securities for a fee, and not generating the sponsorship for the security. They would simply sell the security and drop the client. Drexel developed a superb reputation as market maker.

3. Junk bonds worked to the advantage of **new types of companies** that emerged during the change from industrial "smokestack" companies to the new era. Milken more than others understood the new economy, in particular the growing new service and information companies. Junk bonds, as mentioned above, were used by cellular telephones, cable television, health services, day care, and computers. [Use Robert Sobel's example here on the value of intangibles][53]

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[51] Source ?
[52] My story, Forbes
[53] Sobel, When Giants Fail, 1999

4. Drexel had a superior money raising enterprise. The **highly confident** letters (see above) were unique to Drexel, and Milken never defaulted on one. The idea came from Leon Black, a corporate finance officer in Drexel's East Coast office. Other investment firms had different techniques that served the same function and met with varying degrees of success. For example, a "bridge" loan by an investment bank will be made to get commitment from the investors, and then will be paid off when the investors had put up their money. Drexel's letters of commitment were very successful compared to all the other alternatives. Several Wall Street firms were not successful with bridge loan financing and needed infusions of money from their parent companies to absorb losses in the late Eighties. First Boston, for example, was nearly destroyed in 1990 by its large holdings of high-risk bridge loans.

5. The **loan syndicates** were outside the traditional Wall Street investment bank pools, which was a formidable advantage for Drexel. Other investment banks benefited from the traditional structure where the top or lead banks offered loan participations to other banks in an ordered hierarchy. Drexel would never have benefited from that system (i.e. never have profited on loan syndicates as much as top banks Goldman or Salomon) because Drexel was ranked near the bottom. Furthermore, when it became apparent to the big Wall Street houses that junk bonds were a profitable business, the big houses wanted to participate as syndicate members in the initial share offerings. Milken refused their offers, instead relying on his own syndicate of firms. The major complaint about Drexel's syndicate is that Milken's client base was interlocked to an extent which, to many observers, suggested corruption. There was some evidence, for instance, there was sales pressure on the issuers of bonds to be the buyer of bonds. However, this is no different than the sales style and interlocking interests of the loan syndicates in commercial and investment banks, especially those found in Germany and Japan or those now emerging in the US in the post Glass-Steagal banking world. Some critics exaggerated this point further, claiming that Milken developed "captive" clients, those that were obliged to accept Milken's demands since he allowed them to participate in his alternate syndicate. "Captive" is a very strong term, implying that such customers would accept whatever products Milken offered at whatever time and quantity he offered them.

6. The **manager-owner,** or what Michael Jensen calls the **active investor,** was a new and successful approach to ownership. Drexel promoted the idea by raising money for LBO specialists and raiders. Drexel did not pioneer the LBO, but they were its most successful handmaiden. That is, the new ownership structure created value, many participants in the market could see that and consequently, new enthusiastic investors put their money behind a market-tested idea. Other specialists in mergers and acquisitions (such as Forstmann, Little and Company) chose different forms of funding (other than junk bonds) in order to achieve the same type of success from changes in the structure of ownership.[54] Drexel was more successful on a larger scale, though other companies had notable achievements in this area.

The competitive environment augured by Drexel created a landscape where virtually every firm was a takeover target. The market for **corporate control** would never be the same again. Drexel's ability to accumulate capital forged the hostile takeover market. Such capital is a major financial commitment, and bidders must invest heavily to identify undervalued targets. Bidders need to locate, at significant cost, substantially undervalued firms—not just slightly undervalued firms—in order to recoup their capital costs and searching costs.[55] A potential raider has to present a credible threat in order to function. Drexel, more so than any other investment bank, reinvigorated this crucial market. One estimate of the change in least amount of money one could put up for a takeover bid was down from $1 million before Drexel to as little as $5 thousand after.[56] Thus Drexel and its client firms, such as KKR, affected managerial performance in the United States by making all assets contestable, even if bidding never materialized. Since a high share price is the strongest defense against a hostile takeover, managers were driven to achieve that value for their shareholders.

7. Junk bond funding was often raised for raiders who wished to be anonymous. The **anonymous accumulation** of bond money to buy stock was widely perceived as an

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[54] Source??????

[55] Macey, Corporate Governance, page 103

[56] *The Economist*, Survey on Corporate Governance, page 16_____

unfair form of competition. The **blind pool** was the name given to a fund whose investors' identities are not revealed by Drexel to the public. Companies who were the target of takeovers were "blind" to who its competitors were. Such pools were threatening to potential targets because such targets could not begin effective defense measures against unknown competitors. Large, undisclosed pooling of funds from Drexel's loan syndicate members was a measure of the market power Drexel achieved. Such power suggested a larger market for takeovers and consequently generated additional bitterness from companies that could potentially be targeted. Some argue Drexel abused their market power by not disclosing where the money was coming from. The complaint is that Drexel unleveled and menaced the playing field by having the capacity to issue "highly confident" letters indicating they could raise large sums instantly from anonymous participants.[57] Such pools of money subvert the protectionist legislative spirit of the 1968 Williams Act, since Drexel's "predators" would have an advantage over targets similar to the era before the Act.

8. The junk bond market grew on the demand side as investors developed an appetite for the kind of risk which junk bonds represented. Milken braced the supply side of the market to greet the growing demands of investors. Some critics of the junk bond market said it was plagued by the problem of **"overfunding."** That is, Milken and Drexel allegedly schemed to get companies that supplied bonds to borrow more money than they needed. The additional funds raised by the client company could be used for the original stated purpose of the issue (like internal expansion, for instance) or for other types of investments, such as buying junk bonds to hold or trade for the company's own investment portfolio. A savings and loan, for example, could raise capital by issuing bonds and also be a buyer of bonds. Since issuers of junk bonds could also be buyers, there had always been a suspicion that interlocking debt ownership in this alternative loan syndicate served to hide something. It was suggested that the junk bond market was artificial, and therefore "overfunding" was practiced to inject more money into the market to keep it propped up.

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[57] Bruck, page 18

But consider the basic economics: the quantity of junk bonds issued to the buyers was adjusted by Milken to meet the market demand. Buyers had very good experiences with junk bonds throughout the Seventies and Eighties and wanted more. The notion that bond issues were "overfunded" assumes that the "true" funding amount is known in advance by the participants, and then some other motive (such as market manipulation, back scratching, greed, etc.) causes them to deviate from the "true" quantity. Some interpreters, like Connie Bruck, suggest that there was no economic value in issuing more than was originally intended by the issuer, implying that it is economically irrational to get more than you asked for.[58] But following the price the market will pay is the means of determining what quantity of bonds to bring to market. There is a natural inclination to fund with debt when the costs are advantageous as there is disinclination when the costs are disadvantageous. There is no "true" price prior to the interaction—the final transaction—of supply and demand. Consider the relation between a consumer and a retail bank. A bank offers a credit card amount to a customer higher than the amount the customer requested on the application. The customer can use or misuse the additional money. He can pay some bills or buy a block of lottery tickets. The bank has good reason he'll do the former, not the latter. Perhaps, as a result of the transaction the customer feels good about the deal he made and decides at some future point to conduct some other business with that bank, such as opening a checking account. The bank's reading of the customer has paid off for both parties. There is nothing particularly odd about this financial scenario. With junk bonds, Milken simply offered the client the base amount or more depending on what the market would bear. A high demand for junk bonds meant that Milken could raise more money for clients which they could use as they saw fit. No other investment bank would have a reason to behave differently had they created this market rather than Drexel and Milken. Further, if Drexel could not raise the original requested amount from the outside, they themselves would buy the amount which could not be sold. For example, a company that wanted to raise $1 billion but which Drexel could only place $750 million to the market would find that Drexel bought the remaining $250 million. Other investment banks, for the most part, would reduce the amount issued

[58] Bruck also reports that Tubby Burnham was opposed to this practice.

to $750 million if they could not get full participation.[59] Drexel's sponsorship had a brand name value like no other bank. That particular example happens to be MCI.

9. Drexel was the first investment bank since the time of J. P. Morgan (an early partner of Drexel's in the last century) to engage in **merchant banking,** meaning that they were one of the very few investment banks to take large ownership shares in client companies. The term merchant banking can have a variety of meanings, but the traditional functional meaning is that Drexel used its own capital (in addition to client capital) to finance its deals. It acted as an underwriter and as a debt participant. Some bonds were later converted to equity and warrants were exercised (i.e. stock was bought). In the mid-Eighties, Drexel had equity holdings in roughly 150 firms.[60] Compare Drexel's capacity and investment versatility to a typical commercial bank, a bond mutual fund or an equity buyer's group. A commercial bank can loan money to a company, but there are restrictions on the banks' equity participation, and it can't make a market in the company's stock or direct the company's strategic vision. And there are restrictions on its ability even to restructure the company in the event of trouble. A mutual fund, with a certain charter, is restricted too: a bond fund can't hold equity, so it can't buy and hold the right to purchase stock, a warrant. An equity buyer's group is interested in high adventure, and is not interested in the fixed payments of the bonds: it wants a company that will grow rapidly and appreciate. Drexel had a much larger vision and capacity than any of those three institutions: Drexel could make the market in the company's junk bonds; it could own large segments of equity, debt and convertible securities; its corporate-finance professionals could even be company board directors.[61] Drexel had the flexibility under the changing conditions of the market to take whatever position was both necessary and best for its buyers' group and clients. Thus, in one sense, Drexel broke down the separation of commercial and investment banking (using junk bonds as forms of commercial loans). The form of organization that they revived was a precursor to the mergers of securities firms and commercial banks (such as Alex Brown and Bankers Trust) which began in the mid-Nineties. Drexel saw the necessity of housing

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[59] Bruck, page___
[60] Zey, page 106
[61] Bruck Page 77

both debt and equity activities under one roof, defying over 50 years of regulatory segmentation. In swapping debt for equity or vice versa under changing market conditions, they foreshadowed the kind of efficient financial institution emerging today.

10. Drexel was extremely versatile in managing its own financial stake in client companies. Drexel enhanced its capacities and augmented its capital base by way of having the employees themselves plowing money and profits into internal funding pools. Milken, other executives in Drexel and various clients formed **investment partnerships,** sometimes referred to as employee partnerships**.** These partnerships (over 500 according to Fenton Bailey) supplied capital to Drexel deals and enriched the partners from successful investing.[62] Partnership members included the top Drexel people (roughly 2 percent of the firms employees) and outside luminaries such as performers Kenny Rogers and Lionel Ritchie. Such partnership funds are different from mutual funds in that they have wide investment authority and are limited to sophisticated investors. Typically for a new bid deal, one new partnership would be formed geared to that deal. [Correct?] Retail mutual funds provide capital too, but are much more restricted in what they can do since they are marketed to largely unsophisticated investors. Many other privately held investment firms have similar internal partnerships that can become successful and in turn provide more capital to the firm. Drexel's employees and executives assisted in the financing by putting some of their own money into the deals which they, working for Drexel, organized. Many of these deals were too risky for Drexel (the firm) to conduct on its own. Employee participation in the partnerships made it easier to sell the bonds to outsider buyers, since partnership purchases signaled to potential buyers that the employees of the firm believed in the upside potential of the deal.[63] As a reward for putting personal funds at risk, they were compensated at levels far above ordinary base salaries. Partnership money was invested in Drexel deals in the form of bonds, stocks, convertible securities, warrants, and other vehicles. Other investment banks and private funds with internal investment partnerships could have been as successful if they had Milken and the power of Milken's investment philosophy. The partnerships benefited from Milken's acumen though he did not manage these funds directly. It was reported

[62] Bailey, page 61

that a Drexel employee who was allowed to invest personal funds in a partnership considered it a "sure thing."

One lucrative form of investment for the partnerships was stock warrants. A company that wanted to raise money through debt issuance would often have to offer investors a little more upside than just the bond payment and the possibility of a bond upgrade. Typically, a company would give up some equity in the form of a warrant, an option to buy equity. Drexel would have discretion over how the warrants would be sold. If a potential bond buyer was too skeptical of the debt securities standing alone, he could be offered additional upside in the form of a warrant. (Many bond buyers have a specific investment charter that restricts them from accepting stock-related securities into their portfolios.) A good portion of Drexel's executives' bonus earnings came from investment partnerships that held stocks and warrants. The major complaint about the way Drexel engineered its own position is that they took warrants as part of their fee. Most, but not all, investment banks shunned this practice.

Another drawback of the partnerships was that they offended some of Drexel's employees and clients.[64] Whether such offense is justified is an open question. In theory, there was a line between Drexel's investments and the partnership investments. In practice, such a line could not be cleanly drawn. Former Drexel employee Dan Stone wrote that there was an internal conflict, since the partner-employees could bring in deals and make money from the revenue they generated while benefiting personally from encouraging the firm to absorb the bonds from the deal. In theory, the employee-partners could make money while saddling Drexel with a quantity of barely profitable junk bonds. Employees who were not partners but who had stock in Drexel would suffer, since partners could impose risk on the firm that they themselves did not want to take. To the clients, this reeked of self-dealing and favoritism. It should be noted that this type of conflict was not unique to Drexel since several Wall Street firms were enthusiastic about mergers at this time. Traders were asking their firms to put money into deals (bridge loans) at what turned out to be the top of the market in 1989. When Drexel declared

[63] Fischel, page 131

bankruptcy in early 1990 it was carrying $1 billion in unsold securities held in inventory to close the deals made by its mergers and acquisition department. At the end of the takeover merger wave, First Boston, Shearson and Kidder also had large inventories and were bailed out of trouble by their holding companies.

The extent to which the employee-partners broke discipline is a matter of debate. For example, some of the partnerships at times got better prices than clients (for bonds they bought and sold). To the extent that such activities became (or would become) known to Drexel's customer base, their reputation suffered (or would suffer) accordingly. The uncertainty and ill-will from clients would be reflected in employee (non-partner) attrition, less advantageous fees charged to customers and perhaps a reduced market share.

11. Drexel the firm with the Drexel executives (via partnerships) held a **strip positions,** that is, they held a position in the company that included all parts of the funding, including large equity positions. Merchant banking gave them versatility and they used that versatility to take a particular position, adopt a suitable financial structure, in the deals. Thus, Drexel practiced the idea that they were promoting, namely, that possessing a good portion of the stock could reduce conflict. This meant having a client on the inside of a company that also owned a sufficiently high enough number of shares to "run it like he owned it." Drexel's ownership gave the firm a stake in seeing that its client firm stayed solvent. Recall that the LBO capital structure was designed specifically to avoid the need for debt workouts or bankruptcy proceedings.[65] This financial philosophy was an extension of Milken's core passion about the companies, consistent with Milken's vision of helping companies on the edge of survival. Milken emphasized that the most important factor in analyzing the credit is the manager.[66] Like J. P. Morgan, Milken chose to focus his estimate of the likelihood of loan repayment on the person. Other investment banks served their clients well, no doubt, but Drexel took on a type of borrower to an extent that no competitor matched. When an investment bank is geared toward the

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[64] Stone, page 211 - 213
[65].Opler, "Controlling Financial Distress…", 1993
[66] Stone, page 42

companies of the Fortune 500, it is not attuned to or experienced in the problems faced by low-grade borrowers. Drexel's niche—companies close to the financial edge—required a powerful set of tools to save troubled clients.[67] The strip ownership in particular created a disincentive to bail out at the first sign of trouble. As Frederick Joseph pitched this philosophy: "If you [an executive] do a deal here that goes bad, we're the only firm that keeps you accountable down the road. You've gotta fix it. If you don't try to fix it, I'll kill you."[68] Though a few other investment banks took large equity positions in the companies they raised money for, most banks did not. Drexel emphasized the functional importance of concentrated ownership stakes and earned money on the upside for taking that risk. In combining a theoretical motive with raw fiscal empathy, Milken created an unprecedented form of enterprise that dumbfounded his competitors.

How can an investment bank get into trouble by mismanaging conflicts? Consider the following example, reported in *Institutional Investor* magazine.[69] In the early nineties, a textile company, Burlington Industries, found it bonds plummeting in value. Morgan Stanley had underwritten the company's bonds at the same time that the Morgan Stanley merchant banking fund owned the company. Morgan Stanley's reputation was hurt when angry junk bond investors charged that the firm cared more for the fate of its equity investment than for the fate of the bonds it underwrote. In comparison, Drexel had a far better reputation than other banks in managing the conflicts among creditor classes.

12. Milken **vertically integrated** the two functions of investment banking and trading. This allowed him to better match customers to clients. Traditionally, these are separate stages in a production process. "Initially, I thought of myself as a trader. Talk to a customer. See what he wanted. You discovered he needed products that weren't readily available at the time. So it was clear that we needed to create those products. We had to vertically integrate to produce them if we wanted to serve our customers better than our competitors could."[70] This is why many people came to see Milken as one who "did it all." It was and is unusual for a trader to be creating products, traditionally the domain of

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[67] Bruck page 73-74
[68] Bruck, page 73
[69] Institutional Investor, February 1997, "You Gotta Have Leverage"

the corporate finance department. In so doing, he invited criticism. Vertically integrating these two functions embodies the fusion of the **agent and principal.** He mingled the function of investment banking and trading. The dictionary defines agent as a person, firm, etc. empowered to act for another.[71] A principal is a person who employs another as his agent. An agent is one who facilitates a transaction between principals. In finance, the agents are investment bankers who make the deals. The principals in investment banks are the traders who take a position with the firm's capital.[72] A typical Wall Street firm observes the importance of keeping the functions separate, meaning that the actions of the bankers and traders should be independent of each others influence. For example, typical traders do not influence how deals are structured and priced; they decide independently how much of the firms' capital they should invest no matter how enthusiastic the investment bankers are about a client's deal.

Much has been made of Drexel's break in the firewall that separated the investment bankers (agents) from the traders (principals). The investment bankers have to bring in customers and the traders have to trade in those customers' securities. The trader (in this case, Milken, the top trader) is managing a very large portfolio position (of debt securities). Milken's portfolio of junk bonds was controlled for risk in one way by the matching of bond-buying customers to bond-issuing client. There was less risk since he specifically tailored the product match buyer and seller. Another way risk was controlled within Drexel was by the investment bankers (located in New York) in their initial selection of deals for clients who would be serviced by Drexel. Which risk management technique should prevail when they are in conflict? Milken, on the West coast, tended to prevail. He had a very large say in the amount of funds which could be issued for the clients and the price of the new issue since he was affecting those quantities and prices in his capacity as a trader and tailoring features to meet customer demands. He was making the market and new issues of junk bonds would have to conform to the price and quantity and structure that he influenced by his carefully reading of customer demands. The distinction broke down between managing (by trading) a debt portfolio and the

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[70] My story, Forbes
[71] Webster's New World Dictionary, 1970
[72] Bruck page 64

independent assessment of potential deals. Such decisions tend to made dialectically, between two parties, not simply in the mind of one person. That is what is meant by the fusion of agent and principal. This breakdown was criticized on grounds that it was both an aberration and a power grab by Milken. However, the tension between these two functions was neither a unique occurrence in the investment-banking world nor did its occurrence in Drexel imply the power lust of Milken as the source.

Milken, trading in and out of a (junk bond) loan portfolio, changed the contextual framework of decisions made by Drexel's corporate-finance agents. Subsequently, the very worthiness of new junk bond-related projects became a province of Milken, the trader, as his knowledge and expertise increased over time. Milken did not subvert the role of a separate corporate finance department or the value of fundamental credit analysis in assessing worthiness. But, he made some of the financial analysis extraneous. In practice Milken came to dominate corporate finance: his actions as a principal-minded trader created the conditions under which the Drexel corporate-finance agents selected, structured and conducted deals. Indeed, Milken was often the source of the business and the structurer of the transaction, directly assuming the traditional role of the corporate finance department.[73] Drexel conducted a radical experiment following radical changes in the theory and technology of finance. No other investment bank was dominated by a trader. And none could benefit similarly without the same flexibility in structuring deals. Milken forged a new form of risk management, a new technique, with no guarantees of success or failure.[74] This is coming to be better understood in the 1990s with the proliferation of credit modeling and the shift from a traditional approach to a more finely risk-adjusted approach. The basic criticism of Milken as agent-principal is that, at the time that he was reducing conflicts of interest with his financial engineering techniques, he was also (inadvertently) creating new conflicts of interests within Drexel,

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[73] Bruck page 308

[74] And there this a lot more of this type of portfolio management today. For example, sophisticated credit card issuers have people who market products and people who manage the risks but use the same underlying data to identify the risk return segments of their portfolio. That is , the question of who is likely to default, who is likely to leave, who is likely to be more profitable, who is likely to accept more credit, are all questions that are answered using the same portfolio modeling and analysis techniques. Which is to say, customers are identified and evaluated using identical measures; one's perspective on those customers depends on whether the view is from marketing or risk management. Similarly, Milken succeeded in merging the measures of risk and reward from the trading side and the investment bankers or underwriter in the context of a loan portfolio.

compromising his own ability to be a full, uncompromised, traditional agent for Drexel's clients. In theory, an agent can't act in good faith for a principal whom he represents if the agent himself is also a principal with a large stake in the outcome. The question is open whether, in practice, Milken always acted in good faith on behalf of his clients in a unique role as a hybrid "principle-minded trader." There are a few (often incomplete) examples of alleged "bad faith" offered by critics. [75]

13. Broad diversification of the $4 billion junk bond portfolio was also a means of reducing risk. Such diversification was achieved through the action of trading in and out of the portfolio. Under modern financial theory and practice, the portfolio management theory and independent credit risk assessment also collide. Consider the idea (following Markowitz and Sharpe, above) that the value of a security is determined in the context of other securities in a portfolio. One who manages a portfolio of stocks looks at the contribution of that additional stock to the portfolio, not merely the isolated performance characteristics of the security. By the same reasoning, but not quite to the same extent as a stock portfolio, a debt portfolio establishes the context under which new additional debt is to be valued. To take a simple example, a bank has two credit cards issued to customer A and customer B. All things otherwise equal, if customer A has no other cards from other banks and customer B has five other cards from other banks, the risk of defaulting in payment can be vastly different. The additional risk taken on by lending to customer B might be a reasonable action. This is different than the way banks used to operate where they simply drew a line below which no individual borrower could fall. The traditional approach to evaluating a bank loan or bond is bottom up: investigate individual credit worthiness ("Can this borrower pay us back?"). The new and complementary approach is top down: investigate how a pool or portfolio performs. Loan diversification means in practice that a lender doesn't have to micromanage every loan on the books to the same extent loans were managed in the era before the benefits of diversification were formally recognized. A simple example is the way the mortgage market works today: if mortgage loans are valued in the context of a mortgage pool security, then much of the detailed analysis of each individual borrower ("Did they pay back their student loan 10 years

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ago?") is extraneous since is offers no relevant information to the lender. The recognition of homogeneity and regularity (these loans are alike because they behave the same) is a value discovery. It reduces costs for mortgage lenders, for instance. Milken's reasoning is that a project (a new issue of junk bonds to support a corporate finance deal) can only be valued appropriately in the context of other projects. The additional risk to the holder is lower compared to what other credit assessors (credit rating agencies, Drexel's New York corporate finance department) are judging to be a higher risk. To Milken, it is the relative additional risk that is important, not the absolute isolated risk.

Modern portfolio theory implies that there are deals that fit into your portfolio and are worth doing because of that portfolio, and not necessarily because of a project's particular, native properties. For the average person, is it worth buying a house? Not if you've already got one. Drexel's organization, vilified by many for its structural impertinence and domination by one man, embodied the core theory of modern portfolio theory. That is, it only makes sense to measure the risk of a security in the context of other securities or as a contribution to risk in the presence of other securities.

14. Milken **restructured bonds** of companies that were in trouble. Banks do this all the time. It is unusual for the bond market as a whole, but it is not unusual given that these instruments were low-grade bonds. That is, the nature of the market is such that there will be restructuring of the debt. Traditionally, a liquid market for a security means that there won't be a lot of burdensome covenants and revisions of terms. That is traditionally what banks do in the course of monitoring loans: a borrower gets into trouble and the bank reshuffles the terms of the loan to try to extend the profitable life of the borrower. Milken often said that companies don't get into trouble because of operational problems, but because the finance charges kill them. Drexel was uniquely successful in their sponsorship of companies and restructuring bonds was one critical tool of that sponsorship. Exchanges and refinancings are means of adjusting the finances for companies which have fallen on hard times but whose prospects and/or operational conditions remain positive. (Refinancing is the more general term, and exchanging is one form of refinancing.) Refinancings for firms often occur for similar reasons that

consumers refinance their homes, for example, to take advantage of lower interest rates, higher personal incomes, debt consolidation or to get out of financial trouble. One means of refinancing is exchanging the troubled bonds for new bonds. Drexel's exchanges of the bonds which refinanced troubled borrowers led to the accusation that Milken was engaged in **market manipulation,** about which there is another paper in the future.

Without delving into the other side of Drexel's success, it is important to note that Milken and Drexel were attacked not for any alleged wrongdoing, but for what they were doing that was right. Their approach was reasonable and they were on sound economic footing, though they made some errors of judgment. The powerful negative reaction to Drexel and Milken was not a response to the dark side, but to the bright side. Counter forces against Drexel nurtured a wild attack on the achievement and public authorities dispensed grossly disproportionate punishment for Drexel's minor infractions. They were the most successful Wall Street firm in the Eighties and the punishment they ultimately suffered was proportionate to their success and not their transgression, either real or imagined. But the achievement was real and it was substantive. And Michael Milken became a political prisoner because of that success.

Were any of their unique qualities, capabilities, techniques and organizational approaches illegal? No. However, one can give an iniquitous spin to all facets of their business: there were junk bonds, fast new players, secret agreements, captive clients, strip financing, predatory stalking from blind pools, overfunding, inside employee accounts, broken-down firewalls and market manipulation. There is a mirage of illegality, accompanied by the bitter stench of envy and political ambition. Consider that very few of the commentators have taken the opportunity to give a respectful hearing to Milken's own account. Known as a famous "white collar criminal" even an appearance on a college campus will stir controversy. Like the LBO movement, it is easier to offer sooty motive forces as an explanation rather than consideration of how the investment philosophy that Milken developed played itself out.

Consider also who dominates the junk bond market today. Milken's protégés of the Eighties proliferate in the junk bond market of the Nineties. Most are in senior finance positions and some are prominent junk bond investors. Donaldson, Lufkin & Jenrette (DLJ) hired a dozen of Drexel's junk bond professionals in 1990. When the bond and equity markets rebounded in spring of 1991, DLJ was perfectly positioned to take over much of Drexel's client base at a time when those clients needed to restructure and de-leverage. The explanation for the success of Drexel veterans is that they gained experience working on transactions more varied and complicated than those attempted by their competitors. Even junior people at Drexel did more deals than others did anywhere else. According to one executive recruiter, "Working at Drexel is like having a degree from an Ivy League university…The network stands you in good stead for the rest of your life."[76]

[76] Quote from Dominic Castriota of Rhodes Associates in Atlas, *Institutional Investor*, page 56