Michael Milken

— the junk bond king

Michael Milken emerged as the "king of junk bonds" on Wall Street in the 1980s. In 1989, he faced indictments on 98 felony counts including, stock manipulation, insider trading and racketeering. In a plea-bargain with federal prosecutors he agreed to plead guilty to 6 lesser securities-fraud charges and to pay a $200 million fine and $400 million in restitution. The guilty plea carried with it a potential maximum prison sentence of 28 years, compared to a potential 500 year sentence if he had been convicted on the original charges.

1 Spirited Juvenile

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. His 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.

2 Swift of Interest

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 channelling 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 world view. 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.

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.

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 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.

3 The Financier

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 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.

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 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. 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. At that time in the early Seventies, there were many financial firms 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.

A loyal customer base sustained the junk bond market in its early days. 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. 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. 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.

4 Underwriting and the Coming Catch-22

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. 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.

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. American Motors and Mattel 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 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. 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. 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 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.

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 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.

Milken raised $1.5 billion in 48 hours for Carl Icahn's offer for Phillips Petroleum. 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. 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. 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. 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 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, 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."'

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."

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 drive to understand surely suggests that he was propelled by long range goals rather than fuelled 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.

5 The End

The Securities and Exchange Commission (SEC) filed securities fraud charges against Drexel Burnham Lambert and its superstar investment banker Milken in September, 1988. Drexel Burnham Lambert pleaded guilty to six felony counts, paid $650 million for alleged insider trading violations, and fired Milken rather than facing trial on federal Racketeer-Influenced and Corrupt Organizations (RICO) charges before it collapsed in February 1990 from the weight of the scandal involving its ties to Ivan F. Boesky.

Milken was indicted under in March 1989, and pleaded guilty to six felony counts including securities fraud in April 1990. He was sentenced to prison for 10 years in November 1990 by Judge Kimba Wood and fined more than $600 million: $200 million for securities fraud and $400 million contribution to a settlement fund administered by the SEC. In 1991, Judge Wood decided to cut Milken's sentence from 10 years to 2 years and 10 months, citing Milken's aid to federal prosecutors in other junk-bond cases, and his exemplary behavior in prison. Milken, who reportedly earned $1.8 billion with Drexel Burnham Lambert during his criminal heyday (Drexel paid Milken $296 million in 1986 and a record bonus of $550 million in 1987.), served only 22 months, kept at least $125 million. Barred from the securities business for life, Milken worked as a strategic business consultant for MC Group after his release from prison. The SEC charged that this work was a violation of his probation, and in 1998, Milken and MC Group settled with the SEC and paid the government $42 million and prejudgment interest of $5 million. Milken, who had prostate cancer, established (1993) a foundation to underwrite a search for its cure; he is also a founder (1996) of Knowledge Universe, an educational services company.

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