Chapter 1

The Clash of the Cultures

> When enterprise becomes the bubble on a whirlpool of speculation . . . [and] when the stock market takes on the attitude of a casino, the job [of capitalism] is likely to be ill-done.
>
> —*John Maynard Keynes*

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Throughout my long career, I've observed firsthand the crowding-out of the traditional and prudent culture of long-term investing by a new and aggressive culture of short-term speculation. But the personal experiences that I've outlined in the introduction to this book require deeper discussion—a broader view, an historical perspective, persuasive data—not only of the problems created by this change, but also of recommendations for fixing the nation's financial system. Those are the subjects that I intend to pursue in this chapter.

Let's begin by observing the consequences of the change in the culture of our financial system. When applied to the physical world, scientific techniques have been successfully used to determine cause and effect, helping us to predict and control our environment. This success has encouraged the idea that scientific techniques can be productively applied to all human endeavors, including investing. *But investing is not a science*. It is a human activity that involves both emotional as well as rational behavior.

Financial markets are far too complex to isolate any single variable with ease, as if conducting a scientific experiment. The record is utterly bereft of evidence that definitive predictions of short-term fluctuations in stock prices can be made with consistent accuracy. The prices of common stocks are evanescent and illusory. That's because equity shares are themselves merely *derivatives*—think about that!—of the returns created by our publicly held corporations and the vast and productive investments in physical capital and human capital that they represent.

Intelligent investors try to separate their emotions of hope, fear, and greed from their trust in reason, and then expect that wisdom will prevail over the long term. Hope, fear, and greed go along with the volatile market of short-term expectations, while trust in reason goes with the real market of long-term intrinsic value. In this sense, long-term investors must be philosophers rather than technicians. This difference suggests one of the great paradoxes of the financial sector of the U.S. economy today. Even as it becomes increasingly clear that a strategy of staying the course is inevitably far more productive than market timing, or than hopping from one stock—or a particular mutual fund—to another, the modern information and communications technology provided by our financial institutions make it increasingly easy for their clients and shareholders to engage in frequent and rapid movement of their investment assets.

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The Rise of Speculation

The extent of this step-up in speculation—a word I've chosen as a proxy for rapid trading of financial instruments of all types—can be easily measured. Let's begin with stocks and their annual turnover rate, which is represented by the dollar value of trading volume as a percentage of market capitalization. When I entered this business in 1951, right out of college, annual turnover of U.S. stocks was about 15 percent. Over the next 15 years, turnover averaged about 35 percent. By the late 1990s, it had gradually increased to the 100 percent range, and hit 150 percent in 2005. In 2008, stock turnover soared to the remarkable level of 280 percent, declining modestly to 250 percent in 2011.

Think for a moment about the numbers that create these rates. When I came into this field 60 years ago, stock-trading volumes averaged about 2 *million* shares per day. In recent years, we have traded about 8.5 *billion* shares of stock daily—4,250 times as many. Annualized, the total comes to more than 2 trillion shares—in dollar terms, I estimate the trading to be worth some $33 trillion. That figure, in turn, is 220 percent of the $15 trillion market capitalization of U.S. stocks. To be sure, some of those purchases and sales are made by long-term investors. But even if we look at what are considered long-term investors, precious few measure up to that designation. In the mutual fund industry, for example, the annual rate of portfolio turnover for the average actively managed equity fund runs to almost 100 percent, ranging from a hardly minimal 25 percent for the lowest turnover quintile to an astonishing 230 percent for the highest quintile. (The turnover of all-stock-market index funds is about 7 percent.)

High-Frequency Trading

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The numbers measuring stock market turnover include enormous trading through today's principal market makers: high-frequency traders (HFTs), who are said to presently constitute some 50 percent or more of the total market volume. These HFTs, in fairness, stand ready to provide liquidity to market participants, a valuable service offered for just pennies per share, with holding periods for their positions as short as 16 seconds. Yes, 16 seconds. (This multiple market system, however, has created significant inequities in order execution that demand a regulatory response.) The high demand for the services of HFTs comes not only from "punters"—sheer gamblers who thrive (or hope to thrive) by betting against the bookmakers—but from other diverse sources, as well. These traders may range from longer-term investors who value the liquidity and efficiency of HFTs to hedge fund managers who act with great speed based on perceived stock mispricing that may last only momentarily. This aspect of "price discovery," namely statistical arbitrage that often relies on complex algorithms, clearly enhances market efficiency, which is definitely a goal of short-term trading, but also benefits investors with a long-term focus.

Yes, HFTs add to the efficiency of stock market prices, and have slashed unit trading costs to almost unimaginably low levels. But these gains often come at the expense of deliberate investors, and expose the market to the risks of inside manipulation by traders with knowledge of future order flows. It is not yet clear whether the good aspects of HFT exceed the bad. But despite the claims that all this exotic liquidity is beneficial, one wonders just how much liquidity is actually necessary, and at what price? Paraphrasing Samuel Johnson on patriotism, I wonder if liquidity hasn't become "the last refuge of the scoundrel." There is also an emerging question as to whether, when the markets tumble, the HFTs don't withdraw their trading, depleting market liquidity just when it is needed most.

A few significant anomalies emerge from the large increase in transaction activity, of which HFT is now a major driver. Trading in index funds has also soared, and exchange-traded index funds now account for an astonishing 35 percent of the dollar amount of U.S. equity trading volume. Such trading has increased systemic risk in equities, increased cross-sectional trading volatility, and led to higher correlations among stocks and rising equity risks (measured by higher betas).[1] The benefit of the obvious improvements in liquidity and price discovery created by the current staggering volume of stock trading must be measured against these negative factors. "All that glitters isn't gold."

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Mission Aborted

Consider now how these tens of trillions of dollars of stock transaction activity in the *secondary* market each year compare with transaction activity in the *primary* market. While the secondary market can be criticized as being highly speculative, the primary market provides, at least in theory, capitalism with its raison d'être. Providing fresh capital to business—let's call it capital formation—is generally accepted as the principal economic mission of Wall Street. That mission involves allocating investment capital to the most promising industries and companies,

[1]Rodney N. Sullivan and James X. Xiong, "How Index Trading Increases Market Vulnerability." See footnote 16 in Chapter 6.

both those existing businesses that seek to provide better goods and services at increasingly economic prices to consumers and businesses, and innovators of new businesses that seek to do the same, only de novo. The overwhelming consensus among academic economists agrees that this function provides the rationale for our financial system. But the importance of Wall Street to spurring healthy capital formation is also confirmed not only by the system's detractors, but by major market participants and regulatory leaders.

- Among investment bankers, Goldman Sachs's chief executive Lloyd C. Blankfein has worked hard to underline the social benefits of capital formation. While his claim to be doing "God's work" was a throwaway joke, he has correctly argued that the financial industry "helps companies to raise capital, generate wealth, and create jobs."
- Among the critics, hear *New York Times* columnist Jesse Eisinger: "The financial industry has strayed far from being an intermediary between companies that want to raise capital so they can sell people things they want. Instead, it is a machine to enrich itself, fleecing customers and widening income inequality. When it goes off the rails, it impoverishes the rest of us."
- For an independent view, hear Mary Schapiro, Chairman of the Securities and Exchange Commission: "At the end of the day, if the markets aren't serving their true function—which is as a place to raise capital for companies to create jobs, build factories, manufacture products—if the markets are not functioning as a rational way for investors to allocate their capital to those purposes, what's the point of markets?"

But in reality, how large is that capital formation activity? Let's begin with stocks. Total equity IPOs (initial public offerings) providing fresh capital to young companies have averaged $45 billion annually over the past five years, and secondary offerings providing additional equity capital have averaged about $205 billion, bringing total stock issuance to some $250 billion. The annual volume of stock trading averaged $33 *trillion* during that period, some 130 *times* the volume of equity capital provided to businesses. Put another way, that trading activity represents 99.2 percent of what our financial system does; capital formation represents the remaining 0.8 percent. Now, *that* is a sizable

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imbalance! What is almost universally understood to be Wall Street's mission has been aborted.

The issuance of corporate debt is another function of the economic mission of finance. Over the past decade, new corporate debt offerings averaged about $1.7 trillion annually. But fully $1 trillion of that was accounted for by the now virtually defunct area of asset-backed debt and mortgage-backed debt. Too often these securities were based on fraudulent lending and phony figures that were willingly accepted by our rating agencies, willing coconspirators in handing out AAA ratings to debt securities that would tumble in the recent debacle, their ratings finally slashed. I'm not at all sure that this massive flow of mortgage-backed debt is a tribute to the sacred cow of capital formation.

Futures and Derivatives

This huge wave of speculation in the financial markets is not limited to individual stocks. Trading in derivatives, whose values are derived from the prices of the underlying securities, has also soared. For example, trading in S&P 500-linked futures totaled more than $60 trillion(!) in 2011, five times the S&P 500 Index total market capitalization of $12.5 trillion. We also have credit default swaps, which are essentially bets on whether a corporation can meet the interest payments on its bonds. These credit default swaps alone had a notional value of $33 trillion. Add to this total a slew of other derivatives, whose notional value as 2012 began totaled a cool $708 *trillion*. By contrast, for what it's worth, the aggregate capitalization of the world's stock and bond markets is about $150 trillion, less than one-fourth as much. Is this a great financial system . . . or what!

Much of the trading in derivatives—including stock index futures, credit default swaps, and commodities—reflects risk aversion and hedging. However, a substantial portion—perhaps one-half or more—reflects risk seeking, or rank speculation, another component of the whirling dervish of today's trading activity. Most of this excessive speculation is built on a foundation of sand, hardly a sound basis for our financial well-being. Sooner or later—as the great speculative manias of the past such as

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Tulipmania and the South Sea Bubble remind us—speculation will return to its proper and far more modest role in our financial markets. I'm not sure just when or how, but the population of investors will one day come to recognize the self-defeating nature of speculation, whether on Wall Street or in a casino.

I imagine that I'm not the only author who, poring over his manuscript yet one more time, gets a huge lift when he comes across a perceptive essay in a celebrated newspaper that (at least to the author!) endorses the ideas in his book, even the most controversial ones. So it was when I read the article in the March 3, 2012, issue of *The Economist*. You'll note that virtually every idea in the excerpt in Box 1.1 on the next page echoes the conclusions I express in these next few chapters.

The Wall Street Casino

Way back in 1999, I wrote an op-ed for *The New York Times* entitled "The Wall Street Casino." It called attention to the negative impact of the "feverish trading activity in stocks." At the time, daily trading volume averaged 1.5 billion shares, puny by today's standards. In 2010, the *Times* revisited the issue with an editorial with virtually the same title, "Wall Street Casino." It called attention to the even higher levels of speculation that had come to distort our markets and ill-serve our investors.

To understand why speculation is a drain on the resources of investors as a group, one need only understand the tautological nature of the markets: Investors, as a group, inevitably *earn* the gross return of, say, the stock market, but only before the deduction of the costs of financial intermediation are taken into account. If beating the market is a zero-sum game *before* costs, it is a loser's game *after* costs are deducted. How often we forget the power of these "relentless rules of humble arithmetic" (a phrase used in another context by former Supreme Court Justice Louis Brandeis a century ago), when we bet against one another, day after day—inevitably, to no avail—in the stock market.

Over time, the drain of those costs is astonishing. Yet far too few investors seem to understand the impact of that simple arithmetic, which ultimately causes investors to relinquish a huge portion of the long-term returns that our stock market delivers. Even if the cost of financial market

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Box 1.1

The Economist of London Speaks

"Short-Changed—The Stock Market Is Not Fit for Purpose," by Buttonwood

"The main economic functions of the equity markets are twofold. The first is that savers can participate in economic growth by linking their savings to business profits. The second is to encourage the efficient allocation of capital. These are long-term goals that have virtually nothing to do with the daily fluctuations of the market. The problem is that the regulatory framework has increasingly moved to favor liquidity and trading activity over long-term ownership. . . . The result is an excessive focus on short-term targets. . . .

"Worse still, such frequent reporting has forced bosses to focus on "beating the numbers" at the expense of long-term planning. . . . Performance measures such as earnings per share or return on equity may encourage excessive risk-taking.

"Why haven't shareholders redressed the balance? . . . (Because) most shares are no longer owned by private investors, but by professional fund managers. Those managers are themselves judged on the basis of short-term measures and on their performance relative to a stock market index.

"In short, the current market structure does not seem fit for purpose. How to fix it is not clear. There is clearly no silver bullet. Rewards for long-term shareholders, in the form of tax breaks or better voting rights, may be part of the answer. Smarter rules on executive pay wouldn't hurt. Above all, it would help to remember that the stock market serves a wider goal. It is not supposed to be a sophisticated version of the National Lottery."

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activity—transaction costs, advisory fees, sales loads, and administrative costs—totals as little as 2 percent a year, its long-term impact is huge. Over today's likely 60-year investment lifetime for young investors just starting out, for example, an initial investment earning a 7 percent market return would produce an aggregate gain of 5,600 percent. But after those costs, the return would drop to 5 percent and the cumulative gain to 1,700 percent—less than one-third as much.

The reality of the investment business is that as a group, we investors don't get what we pay for, which is the returns earned by our corporations. We get precisely what we *don't* pay for. So, as strange as it sounds, the less we pay as a group, the more we get. And if we pay nothing, (or almost nothing, as in an all-stock-market index fund) we get everything, the market return. There's simply no way 'round these mathematics of the markets. This financial math, of course, is the very same model as the casino math on which the so-called gaming industry relies. The winning clients' good luck is balanced by the losing clients' bad luck. But regardless of winners or losers, the croupiers rake off the house share of every bet. It's not just Las Vegas or Foxwoods or Atlantic City, but it's also our pervasive state lotteries (think Mega Millions and Powerball), except that in these giant lotteries, the croupier's take, relative to the amount wagered, is even higher than in the Wall Street casino and our nation's racetracks and gambling dens.

Calling Wall Street a casino, of course, is not entirely fair. Wall Street is more than that. It provides the liquidity on which long-term investors as well as short-term speculators rely. Wall Street also facilitates the capital formation mentioned earlier, however small relative to today's stock market volumes. But every once in a while, even a market insider acknowledges the similarity. Late in 2010, a senior executive of Wall Street powerhouse Cantor Fitzgerald owned up to the obvious, stating, "I don't see any difference between Las Vegas Boulevard and Wall Street: Over time we can't lose, but there will be games where we take a hit."

This executive is explaining why Cantor Fitzgerald, one of the largest brokers in super-safe (so far!) U.S. government securities, is now running sports bookmaking at a new casino in Las Vegas. "There's big

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money in . . . moving onto the strip," another Cantor executive added, especially through a new license that allows sports betting, roulette, and slot machines (so far, only in Nevada) on mobile devices. Could Wall Street, where you can now trade stocks on cell phones, be far behind? Indeed, with all the computing power, the technology, the quantification, and the algorithms we have today—and the enormous size of financial gambling relative to casino gaming—Wall Street already is far ahead.

How Speculation Overwhelmed Investment

Today's domination of financial markets by the loser's game of speculation over the winner's game of investment is no accident. It has been fostered by critical changes in the elements of investing. First in my list of causes is the decline of the old ownership society in favor of a new agency society where the tables have been turned. In 1950, individual investors held 92 percent of U.S. stocks and institutional investors held 8 percent. The roles have flipped, with institutions, now holding 70 percent, predominating, and individuals, now holding 30 percent, playing a secondary role. Simply put, these institutional agents now collectively hold firm voting control over Corporate America. (I discuss these agency issues much more fully in Chapter 2.)

Originally managers of pension funds and mutual funds, and later of hedge funds, these new investor/agents were hardly unaware of their own financial interests. As a group—with far too few exceptions—they took advantage of their agency by charging high advisory fees and adopting investment policies that focused on the short-term. In part, they recognized that their clients would judge them based on these terms. Mutual fund managers capitalized on the reality that hot, short-term performance—even though it couldn't last (and didn't)—would enrich them with higher fees. In order to reduce pension contributions and enhance short-term earnings, corporate pension executives projected totally unrealistic high future returns. State and local government officials, pressed by labor unions for higher wages and pensions, not only did the same, but failed to provide financial disclosure that revealed—or even

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hinted at—the dire long-term financial consequences that are already beginning to emerge.

The Decline in Unit Transaction Costs

It wasn't just the rise in institutional ownership that fueled the rise of speculation. Speculation was also fueled by the dramatic decline in transaction costs. Simply put, trading stocks got a whole lot cheaper. Taxes virtually disappeared as a limiting factor in stock sales. The lion's share of the assets managed by these now-dominant, powerful investment institutions were in accounts managed for tax-deferred investors such as pension plans and thrift plans, and in tax-exempt accounts such as endowment funds. Even for taxable clients, mutual fund managers supervised the assets in very much the same way, simply ignoring the tax impact and passing the tax liability through to largely unsuspecting fund shareholders. So over time, these agents came to ignore income taxes and capital gains taxes, essentially eliminating them as a major frictional cost in executing portfolio transactions, a cost that had helped to deter rapid stock trading in an earlier era.

Next, in a wonderful example of the law of unintended consequences, commissions on stock trading were slashed, virtually removing the trading cost of transactions. Fixed commissions of about 25 cents per share that had pretty much prevailed up until 1974 were eliminated in favor of commissions set in a free market. Wall Street, otherwise a bastion of free-market capitalism, fought the change to competitive rates with vigor (and money), but finally lost. The decimalization of stock prices, begun in 2001, also took its toll as commissions fell to pennies per share as *unit costs* of stock trading were reduced to bare-bones minimums. Nonetheless, with soaring trading volumes, Wall Street's *total commission revenues* appear to have doubled in the past decade, more than making up for the decline in rates.

It may be stating the obvious to note that great bull markets often foster speculative activity. After all, how much measurable harm could even the earlier drag of taxes and commissions inflict on returns when the S&P 500 Index rose more than tenfold from 140 in 1982 to 1,520 at the 2000 high? What's more, when a culture of high-volume trading

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becomes embedded in the system, even a bear market that took the S&P 500 to a low of 680 in the spring of 2009 couldn't break the trend toward high trading activity. In some respects, the events of the past few years seem actually to have enhanced the rate of speculation.

Hedge Fund Managers and Other Speculators

The development of this culture of speculation was accelerated by a new breed of institutional investor—the hedge fund, which typically turns over its portfolios at a 300–400 percent annual rate. From a single U.S. hedge fund in 1949, the field has burgeoned to some 4,600 hedge funds today, with assets under management of some $2 trillion, albeit down from $2.5 trillion at their peak a few years ago. While some hedge funds have had remarkably good performance, the failure rate, which is the rate that funds that go out of business, is large. Indeed, some estimates suggest that the failure rate is around 20 percent, meaning that each year, one of every five hedge funds goes up in smoke. Including the earlier records of such funds with those of hedge funds that have survived, they seem to perform no better than, well, average.

For example, over the past 10 years the average hedge fund produced an annual return after fees (but before taxes) of 4.6 percent, compared to 6.2 percent for a pioneering, stodgy, low-risk, low-cost conservative balanced mutual fund named Wellington Fund. Since the traditional "2 and 20" management fee structure—2 percent of assets annually, plus the "carry" of 20 percent of realized and unrealized profits—likely consumed as many as 3 percentage points a year of the *gross* returns of the average hedge fund, small wonder that the *net* returns have been, at best, undistinguished. (I write more about Wellington's costs in Chapter 8.)

While hedge funds may have led the speculative wave, many pension funds and mutual funds also moved toward the new, quantitatively oriented, high-turnover strategies, as ever more sophisticated computer hardware and software made data almost universally available. Analysts and academics alike massaged the seemingly infinite data on stock prices to the nth degree, often using complex techniques—relative

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valuations, classes of stock (growth versus value, large versus small, etc.), market momentum, changes in earnings estimates, and many others.

Each of these models was designed to provide *positive Alpha* (excess return over a market benchmark), which came to be seen as the Holy Grail of consistent performance superiority. But too few in the profession asked the existential question: Does that Holy Grail actually exist? No. Positive Alpha does not exist—cannot exist—for investors as a group, who earn zero Alpha before costs, and negative Alpha after costs.

Another great fomenter of this new rapid trading environment was, of course, *money*. Not only big money for hedge fund managers, but big money for brokers and investment bankers, big money for mutual fund managers; and, collectively at least, big money for all those lawyers, marketers, record keepers, accountants, prime brokers, and bankers who are part of the extraordinarily well-paid constituency of our casino society. Inevitably, as noted earlier, every dollar of this big money comes directly out of the pockets of the industry's clients.

In fairness, the rise of speculation also seems to reflect a broader change in our national culture. All across American life, trusted professions—traditionally focused on service to the community—have increasingly taken on the characteristics of businesses—focused on maximizing profits to providers of capital, too often at the expense of the moral values of an earlier age. What's more, a gambling culture, always part of our society, seemed to first strengthen and then ultimately prevail, a diversion from the hard times that so many of our families are going through.

Whether gambling on stocks or in casinos (where the odds are even worse), we have given even the relatively wealthy a means to quickly build their wealth, and low-income families who need it most an opportunity to prosper at last—even though the odds that they will succeed are terribly long. What's more, we Americans like to buy things—in abundance—before we have the cash to pay for them. We focus on today's wants rather than tomorrow's needs. Even our wealthiest citizens never seem to have *enough*. We compare ourselves with our neighbors and, since the realities of life can be so hard to overcome, we look to speculation—even at long odds—to lift us out of the everydayness of our lives.

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We Can't Say We Weren't Warned

Long ago, the possibility that speculation would come to play a far larger role in finance concerned the legendary investor Benjamin Graham. Way back in 1958, in his address to the New York Society of Financial Analysts, he described what he saw as the coming change in culture as "some contrasting relationships between the present and the past in our underlying attitudes toward investment and speculation in common stocks." Some excerpts from this address follow in Box 1.2.

Box 1.2

The Prescience of Benjamin Graham—1958

"In the past, the speculative elements of a common stock resided almost exclusively in the company itself; they were due to uncertainties, or fluctuating elements, or downright weaknesses in the industry, or the corporation's individual setup. . . . But in recent years a new and major element of speculation has been introduced into the common-stock arena from outside the companies. It comes from the attitude and viewpoint of the stock-buying public and their advisers—chiefly us security analysts. This attitude may be described in a phrase: primary emphasis upon future expectations.

"The concept of future prospects and particularly of continued growth in the future invites the application of formulas out of higher mathematics to establish the present value of the favored issues. But the combination of precise formulas with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wished, however high.

"Given the three ingredients of (a) optimistic assumptions as to the rate of earnings growth, (b) a sufficiently long projection of this growth into the future, and (c) the miraculous workings of compound interest—lo! The security analyst is supplied with a

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new kind of philosopher's stone that can produce or justify any desired valuation for a really "good stock."

"Mathematics is ordinarily considered as producing precise and dependable results; but in the stock market the more elaborate and abstruse the mathematics, the more uncertain and speculative are the conclusions we draw therefrom. . . . Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator was trying to substitute theory for experience, and usually also to give to speculation the deceptive guise of investment.

"Have not investors and security analysts eaten of the tree of knowledge of good and evil prospects? By so doing have they not permanently expelled themselves from that Eden where promising common stocks at reasonable prices could be plucked off the bushes?"

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Graham's reference to Original Sin reflected his deep concern about quantifying the unquantifiable, and doing so with false precision. When Graham spoke these words in 1958, the consequences of that bite into the apple of quantitative investing were barely visible. But by the late 1990s, this new form of investment behavior had become a dominant force that continues to be a major driver of the speculation that has overwhelmed our financial markets. Eden is nowhere to be seen.

The Wisdom of John Maynard Keynes

Years before Benjamin Graham gave his landmark speech in 1958, we were also warned about excessive speculation by another legendary figure. The great British economist John Maynard Keynes drew a firm distinction between investment and speculation, and did so in words of great clarity and simplicity.

The change in the culture of financial markets—the broad trend toward the dominance of speculation over investment—and in the conduct, values, and ethics of so many market participants has been

fostered by the profound change that has taken place in the *nature* of our financial markets. That change, largely unnoticed, reflects two radically different views of what investing is all about, two distinct markets, if you will. One is the *real* market of intrinsic business value. The other is the *expectations* market of momentary stock prices.

It's a curious coincidence that I've been concerned about this sharp dichotomy ever since I first encountered Lord Keynes in my study of economics at Princeton University as an undergraduate student. Really! In my 1951 senior thesis, inspired by a 1949 article in *Fortune* on the then "tiny but contentious" mutual fund industry, I cited a critical distinction made by Lord Keynes. He separated "forecasting the prospective yield of the asset over its whole life"—*enterprise* (what I call *investment*)—from *speculation*—"forecasting the psychology of the markets."

Speculation Will Crowd Out Investment

Keynes was deeply concerned about the societal implications of the growing role of short-term speculation on stock prices. "A conventional valuation [of stocks] which is established [by] the mass psychology of a large number of ignorant individuals," he wrote in 1936, "is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really matter much to the prospective yield . . . resulting in unreasoning waves of optimistic and pessimistic sentiment."

Then, prophetically, Lord Keynes predicted that this trend would intensify, as even "expert professionals, possessing judgment and knowledge beyond that of the average private investor, would become concerned, not with making superior long-term forecasts of the probable yield on an investment over its entire life, but with forecasting changes in the conventional valuation a short time ahead of the general public." As a result, Keynes warned, the stock market would become "a battle of wits to anticipate the basis of conventional valuation a few months hence, rather than the prospective yield of an investment over a long term of years."

In my thesis, I cited those very words, and then had the temerity to disagree with the great man. Portfolio managers, in what I predicted—accurately, as it turned out—would become a far larger mutual fund

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industry, and would "supply the market with a demand for securities that is *steady, sophisticated, enlightened, and analytic* [italics added], a demand that is based essentially on the [intrinsic] performance of a corporation [Keynes's *enterprise*], rather than the public appraisal of the value of a share, that is, its price [Keynes's *speculation*]."

Alas, the steady, sophisticated, enlightened, and analytic demand that I had predicted from our expert professional investors is now only rarely to be seen. Quite the contrary! Our money managers, following Oscar Wilde's definition of the cynic, seem to know "the price of everything but the value of nothing." As the infant fund industry matured, the steady, sophisticated, enlightened, and analytic demand that I had predicted utterly failed to materialize, while speculative demand soared. So, six decades after I wrote those words in my thesis, I must reluctantly concede the obvious: Keynes's sophisticated cynicism was right, and Bogle's callow idealism was wrong. Call it Keynes 1—Bogle 0. But that doesn't mean we should allow that system to prevail forever.

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Fixing the Social Contract

Today's dominance of a culture based on short-term speculation instead of long-term investment has major implications that go far beyond the narrow confines of our financial sector. It distorts our markets and ultimately distorts the way our businesses are run. If market participants demand short-term results and predictable earnings in an inevitably unpredictable world, corporations respond accordingly. When they do, there is heavy pressure to reduce the workforce, to cut corners, to rethink expenditures on research and development, and to undertake mergers in order to "make the numbers" (and often to muddy the accounting waters).

When companies are compelled by short-term speculators to earn a return on their capital as it is valued by the price of its stock set by the *expectations* market, rather than the intrinsic value of the capital provided to them by their shareholders in the *real* market, the task of fulfilling the two roles can become nigh impossible. Indeed, any attempts to do so may lead to dire consequences for company employees, for their communities, for the integrity of the products and services they provide, and even for their long-term viability. When a corporation's focus on meeting Wall Street's expectations (even its demands) takes precedence over

providing products and services that meet the ever-more-demanding needs of today's customers, the corporation is unlikely to serve our society as it should. Yet that corporation's service to its customers and the broader society is the ultimate goal of free-market capitalism.

Perhaps even more important, we've largely lost the essential link between corporate managers and corporate owners. Ownership has its privileges—one of the most important of which is to ensure that the interests of shareholders are served before the interests of management. But most short-term *renters* of stocks are not particularly interested in assuring that corporate governance is focused on placing the interests of the stockholder first. Even long-term *owners* of stocks have not seemed to care very much about exercising their rights—and indeed their responsibilities—of stock ownership.

The agency society I've described earlier has too often failed to lend itself to significant involvement in corporate governance. Index funds ought to be in the vanguard of serious reforms, for they can't and don't sell stocks of companies whose managements are deemed to have produced inadequate returns on the capital they oversee. Despite the growing importance of index funds, many managers are loath to rock the boat, let alone engage in a more muscular activism, including proxy proposals, director nominations, executive compensation, and vigorous advocacy.

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Compensation Issues

Consider executive compensation. While it is now absurdly excessive, it is generally ignored by shareowners. Consider, too, the corporate political contributions, only now subject to even limited disclosure to the funds' owners. Part of the challenge is that our institutional investors too often have a different agenda from that of the fund shareholders and pension beneficiaries they represent. Like the corporate managers they oversee, these money managers are too often inclined to put their own interests first, taking advantage of their agency position. (I discuss both of these subjects—the agents who manage our corporations and the large investment pools, and participation in corporate governance—in more depth in the following two chapters—"The Double-Agency Society and the Happy Conspiracy" and "The Silence of the Funds.")

It is surely one of the great paradoxes of the day that the largest financial rewards in our nation are received by an investment

community that *subtracts* value from its clients, with far smaller rewards received by a business community that *adds* value to society. Ultimately, such a system is all too likely to bring social discord to our society and engender a harsh public reaction to today's record disparity between the tiny top echelon of income recipients and the great mass of families at the base. The highest-earning 0.01 percent of U.S. families (150,000 in number), for example, now receives 10 percent of all of the income earned by the remaining 150 million families, three *times* the 3 to 4 percent share that prevailed from 1945 to 1980. It is no secret that about 35,000 of those families have made their fortunes on Wall Street.

Creating Value versus Subtracting Value

In yet another distortion aided and abetted by our financial system, too many of the best and brightest young people in our land, instead of becoming scientists, physicians, educators, or public servants, are attracted by the staggering financial incentives offered in the investment industry. These massive rewards serve to divert vital human resources from other, often more productive and socially useful, pursuits. Even in the field of engineering, "financial" engineering, which is essentially *rent-seeking* in nature, holds sway over "real" engineering—civil, electrical, mechanical, aeronautical, and so on—which is essentially *value-creating*. The long-term consequences of these trends simply cannot be favorable to our nation's wealth, growth, productivity, and global competitiveness.

Finally, the dominance of speculation in our financial affairs shifts our society's focus from the enduring reality of corporate value creation, on which our nation ultimately depends, to the momentary illusion of stock prices. We spend far too much of the roughly $600 billion annual cost of our investment sector on what is essentially gambling. It may be intelligent and informed gambling, but gambling on the notion that the wit and wisdom and algorithms of one firm can capture an enduring advantage over another has been shown over and over again to be a bad gamble. (Evidence supporting the systematic achievement of sustained superiority simply does not exist.) So perhaps we should listen carefully when Lord Adair Turner, chairman of Britain's Financial Services Authority, describes much of what happens in the world's financial centers as "socially useless activity." I have often pointed out much the same thing: "The stock market is a giant distraction from the business of investing."

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Once again, I'm not alone in my concern about this obvious dominance of the culture of speculation over the culture of investment in our financial markets. Indeed, I'm proud to associate my philosophy with that of legendary financial economist Henry Kaufman, whose wisdom places him in the top echelon of the worthy mentors of my long career. In Box 1.3 I present excerpts from his 2001 book *On Money and Markets: A Wall Street Memoir*. While his words were written a decade-plus ago, they hit home even more strongly in the years following the 2008 financial crisis that has slammed into our economy, our society, and our communities, it is high time that we take his wisdom to heart.

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Box 1.3

The Timeless Wisdom of Henry Kaufman (2001)

"The United States has not sustained a proper balance between financial conservatism and financial entrepreneurship—the fundamental and long-standing tension between two broad financial groups. At one end of the spectrum are financial conservatives, who favor preserving the status quo in the marketplace and hold in high esteem the traditional values of prudence, stability, safety, and soundness. At the opposite end are financial entrepreneurs—risk takers restlessly searching to exploit anomalies and imperfections in the market for profitable advantage. They consider existing laws and regulations to be fair game, ripe to be tested and challenged.

"The modern quantitative and econometric techniques developed in the last generation have given investors and portfolio managers a new sense of confidence in the ability to forecast financial trends and behaviors. By compiling and analyzing historical data, and by building models that take into account current variables, econometricians often try to predict the movement of interest rates, stock prices, inflation, unemployment, and so on. During times of financial euphoria and investor panic, however,

these techniques become virtually worthless. The reason is fairly simple: The vast majority of models rest on assumptions about normal and rational financial behavior. But during market manias, logical and analytical minds do not prevail. Such markets are driven more by hubris, elation, fear, pessimism, and the like—emotions that the current models do not, and perhaps cannot, compute.

"People in finance are entrusted with an extraordinary responsibility: other people's money. This basic fiduciary duty too often has been forgotten in the high-voltage, high-velocity financial environment that has emerged in recent decades. With the absorbing excitement of the trading floor—which for some becomes a sort of game, an end in itself—the notion of financial trusteeship is frequently lost in the shuffle. In the final analysis, the tilt toward unbridled financial entrepreneurship has exacted economic costs that often far outweigh their economic benefits. Only by improving the balance between entrepreneurial innovation and more traditional values—prudence, stability, safety, soundness—can we improve the ratio of benefits to costs in our economic system.

"Today's financial community is suffering from a bad case of amnesia. Most Wall Streeters are unaware of or have forgotten about the damaging effects of irresponsible behavior in their rush to "innovate" and profit. Business majors at most colleges and universities were once required to take courses in business and financial history, while the history of economics and economic thought was a staple in economics programs. This is no longer the case. In their entrancement with new quantitative methods, most business schools long ago abandoned their historically oriented courses. Anything having to do with the qualitative side of business practice—ethics, business culture, history, and the like—was subordinated or eliminated as being too "soft" and "impractical." Yet only a long historical perspective can help us sort out what is lasting and salient from what is ephemeral and faddish. In finance, as in all human endeavors, history has valuable lessons to teach."

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Restoring Balance in Our Investment Sector

Although our financial sector in many ways functions in a different fashion from our productive economy, the two are hardly independent. As the economist Hyman Minsky has pointed out, "Since finance and industrial development are in a symbiotic relationship, financial evolution plays a crucial role in the dynamic patterns of our economy."

So, the dominance of today's speculative orientation requires not only thought but also corrective action. In the effort to restore a sounder balance between investment and speculation in our financial sector, there are many actions that we should consider. While each has much to recommend it, any action must withstand rigorous intellectual analysis of its consequences, and also withstand the resistance of powerful detractors with vested interests in the status quo. So now let's consider some of the possibilities, as well as the benefits to society, if we can better rebalance the two cultures of investors.

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Tax Policies and Financial Transactions

Taxes can be brought back into play, replacing some of the frictional costs of investing that served to moderate the speculation that prevailed in an earlier era. Years ago, Warren Buffett suggested a tax on very short-term capital gains realized by both taxable and tax-deferred investors. (He says he was speaking tongue-in-cheek.) Alternatively, taxes on transactions, as suggested by professor James Tobin years ago, should be considered—perhaps in the range of one to five basis points (0.01 percent−0.05 percent of the value of the transaction). It should be paid by both the buyer and the seller of the shares, but not by the market makers. This kind of Pigouvian tax,[2] which is essentially a "sin" tax designed to elicit appropriate behavior, is generally unpopular not only with investment managers, but with economists as well. But it deserves a fair hearing. Less radically, disallowance of the tax deduction for short-term losses is also an idea worth pursuing. Yes, the lower trading volumes that would likely result from tax changes such as these could negatively impact liquidity in

[2] After Arthur Cecil Pigou, British economist of the early twentieth century.

our markets, but do we really need today's staggering levels of turnover, quantum amounts above the norms of a half-century ago?

Taxes on earnings from stock trading should also be considered. A century ago, President Theodore Roosevelt distinguished between activities with positive utility that add value to our society and activities with negative utility that subtract value from our society. He referred to speculators as "the men who seek gain, not by genuine work, but by gambling." If trading pieces of paper is akin to gambling (remember the earlier "casino" example), why should trading profits not be subject to *higher* rates? Yet we live in an Alice-in-Wonderland world in which even that hedge fund "carry" mentioned earlier is subject to substantially *lower* rates. Such income is subject only to the minimal taxes applicable to long-term capital gains rather than the higher taxes on ordinary earned income. I can't imagine how our legislators can continue to endorse such an absurd and unfair tax subsidy, one that favors highly paid stock traders over the modestly paid workers who, by the sweat of their brows and the furrows of their brains, provide the valuable products and services that give our nation the living standards that are the envy of the world.

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Develop Limits on Leverage, Transparency for Derivatives, and Stricter Punishments for Financial Crimes

We need stronger, smarter, and wiser regulation that is principles-based where possible, and rules-based in all other cases. No, I do not believe that our government should run our financial sector. But I would be willing to accept the cost of its inevitable bureaucratic drag on the system since, after all, most government activity itself is also rent-seeking rather than value-adding. Regulation is needed in order to:

- Establish and enforce sterner limits, as appropriate, on leverage and portfolio quality.
- Bring the opacity of today's derivatives trading into the bright sunlight of transparency and openness, with public reporting of all transactions.

- Develop much stronger rules that would preclude—or at least minimize—obvious malfeasance such as insider trading, conflicts of interest, and the remarkably widespread Ponzi schemes that we've recently witnessed.

Yes, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 attempted to deal with some of these issues. Certainly derivative transparency will be a plus, as will new requirements for banks' capital. But after all the horse trading between Democrats and Republicans—and reformers, bankers, and lobbyists—I fear that its complex, obtuse regulations (some 170 separate rules are still being developed) involved in limiting proprietary trading by banks makes me wish we'd taken the simple step of restoring the separation of *deposit taking* banks from *investment* banks. The Glass-Steagall Act of 1933 worked well until it was gradually eroded and finally repealed in 1999.

We've had too much crime and not enough punishment in our financial sector. I'd like to see far harsher penalties for white-collar criminals who abuse their clients' trust. But, I salute the federal authorities for bringing wire-tapping into play in their prosecutions of insider trading, earning tough victories over highly placed executives who thought they could get away with breaking the law. The jail sentences now being imposed will do more to deter these criminals than any other form of punishment. We also need far better data on most of the issues I've raised in this chapter. Sound regulation can foster such transparency, and the new Dodd-Frank–created Office of Financial Research (OFR) will be a big step. So will the parallel Bureau of Consumer Protection, now at least functioning after an ugly political dogfight.

The Rules of the Game

The rules of the game and the appropriate behavior of its players also must be regulated. However, I hold as a general principle that government should, under nearly all circumstances, keep its hands off the free functioning of the marketplace. I wince when the Federal Reserve states its intention to raise asset prices—including "higher stock prices"—apparently irrespective of the level of underlying intrinsic stock values.

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Substantive limits on short selling are another nonstarter for me. The overriding principle should be: *Let the markets clear*, at whatever prices that willing and informed buyers agree to pay to willing and informed (but often better-informed) sellers.

Individual investors need to wake up. Adam Smith–like, they need to look after their own best interests. Of course, that would mean that individual investors must demand much better, clearer, and more pointed disclosures. We need a campaign to educate investors about the hard realities of investing. Investors need to understand not only the magic of compounding long-term returns, but the tyranny of compounding costs; costs that ultimately overwhelm that magic. (I presented the math earlier in this chapter.) Investors need to know about sensible asset allocation and the value of diversification; they need to understand the huge gap that exists between the illusion of *nominal* returns and the reality of *real* (after-inflation) returns; they need to recognize that short-term trading—like casino gambling—is ultimately a loser's game, and they need to understand the demonstrated costs of the behavioral flaws that plague so many market participants. As I suggested earlier—*investments usually perform better than investors.*

Our financial money manager/agents should focus primarily on long-term investment, to act as prudent trustees of the "other people's money" that they oversee. Financial institutions are trustees, they should behave as such. Investment professionals need to do a far better job of due diligence. We need to focus on investment fundamentals. We need to assume the rights and responsibilities of corporate governance. We need to take on an activist role in assuring that the companies whose shares our institutional manager/agents hold and control are run in the interest of the investor/principals whom we are bound to serve as fiduciary agents. A big step in the right direction would be the enactment of a federal standard of fiduciary duty for those who put themselves forth as trustees. This standard would include a long-term investment focus, due diligence in security selection, participation in corporate affairs, reasonable fees and costs, and the elimination of conflicts of interest. (In Chapters 3 and 4, I discuss the subject of fiduciary duty and explain some standards for measuring it.)

Finally—and this may surprise you—we institutional managers need a far deeper sense of caring about our clients' interests to permeate our

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conduct and values. We need introspection—that rarest of qualities—from today's leaders of our financial sector as well as tomorrow's. We need leaders with integrity and wisdom, leaders with a sense of history; a sense of the conditions, practices, and character of our present financial sector; and a sense of what we want our field to look like in the decades down the road. It all comes down to a better understanding of what has been, what is, and what will be. Is today's system what we would design if we were present at the creation of a new system designed to serve our investors, our communities, and our society at large? If we can do better, isn't it time for those of us who care about the future of the financial profession to stand up and be counted? As it is said, "If I am not for myself, then who will be for me? And if I am only for myself, then what am I? And if not now, when?"

The Goal: Stewardship Capitalism

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We must seek a financial sector of a size appropriate to its capital formation responsibilities, to its ability to provide liquidity for long-term investors as well as speculators, and to its responsibility for our nation's 150 million individual investors. We must seek an investment sector in which a culture of stewardship and longer-term thinking dominates a culture of speculation, short-term trading, salesmanship, and marketing, however necessary they may be in moderate doses. We must seek a culture of financial trusteeship and fiduciary duty that should play the *starring role* in the long saga of investment, with entrepreneurial innovation and speculation playing only a *supporting role*—the exact opposite of the way the system works today. In this new and better-balanced culture, our financial sector should do a far better job of earning sound returns for our investors at competitive costs, all the while assuming reasonable risks. It is the responsibility of our financial system to deliver to our nation's families—who are ultimately the providers of all of the capital investment in our economy—their fair share of whatever returns our corporate businesses are able to generate over an investment lifetime.

In the course we choose, there's a lot at stake for today's beleaguered system of free market capitalism. Lord Keynes got it right with the warning with which I began this chapter: *When enterprise becomes the bubble*

on a whirlpool of speculation . . . [*and*] *when the stock market takes on the attitude of a casino, the job* [*of capitalism*] *is likely to be ill-done*. No matter how each of us may feel about the issues raised in this chapter, that's the one thing that none of us can afford to have happen. For free market capitalism is the best system ever devised for the allocation of economic resources, risks, and rewards. In Chapter 2, I discuss how its proper functioning was so substantially diminished during the recent era.

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