THE AMAZING DISAPPEARANCE OF THE INDIVIDUAL STOCKHOLDER
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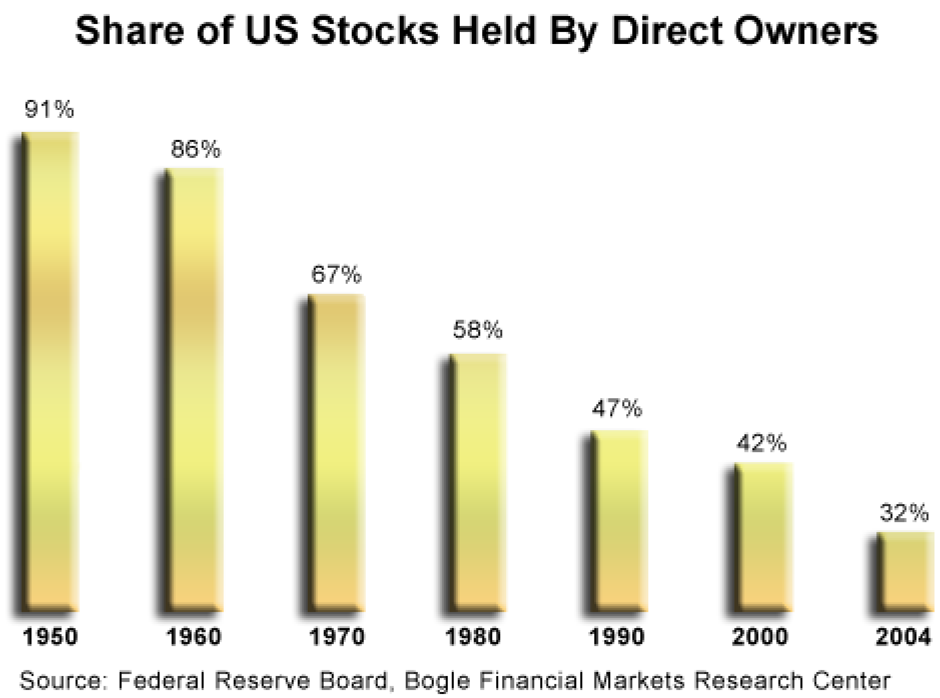
The amazing disappearance of the individual stockholder as the backbone of the U.S. stock market has been one of the least recognized but most profound trends of the last half-century. As shown in the chart nearby, direct ownership of stocks by American households has declined from 91% in 1950 to just 32% today.



The 9% ownership stake held by financial institutions in 1950 crossed the 50% mark in 1983, and now totals 68% of all stocks. It is hard to imagine that our earlier society dominated by individual stock ownership will ever return.

Of course individual investors remain major participants in the stock market, but now do so largely through mutual funds and public and private pension plans. But such participation lacks the traditional attributes of ownership such as selection of individual stocks and engagement in the process of corporate governance.

But aren't our financial institutions owners of stocks? Not really. They are owners in name, but in fact are agents with a duty to act on behalf of their principals, including our mutual fund owners and beneficiaries of our retirement plans. Today's agency-dominated investment society is overwhelmingly composed of those two groups of underlying owners.

At first, the march toward institutionalization was led by pension plans. Holding less than 1% of all stocks in 1950, they shot up to 19% in 1980 and 27% in 1989-95, only to ebb to today's level of 21%. Growth in mutual-fund ownership, on the other hand, was stagnant in the early years, holding at 3% in 1950 and 1980 alike, rising to just 8% by 1990. Since then, fund ownership of stocks has risen relentlessly to a record high of 28% currently.

Within the pension segment, public plans are holding steady while private pension plans are gradually receding. But the secular decline in defined-benefit pension plans has been matched by an offsetting rise in defined-contribution thrift and savings plans in which mutual funds are the major component. So today's dominant stock ownership by mutual funds seems destined for continued growth.

Institutional investing is now largely the business of giants. America's 100 largest money managers alone now hold 58% of all stocks. When such a relative handful of professional managers substantially displaces a diffuse group of tens of millions of inchoate individual investors, one might have expected the managers to more aggressively assert their rights of stock ownership and demand more enlightened corporate governance focused on shareholder interests. With few notable exceptions, however (some state and local pension plans, unions, and TIAA-CREF), our institutional investors have refrained from active participation in corporate affairs.

What explains the passivity of these institutions that in fact hold effective control over corporate America? First, too many of our financial agents have their own interests to serve, often conflicting with the interests of their investor-principals. It is a truism that principals are likely to watch over their own money with far more care than they take in watching over the assets entrusted to them as the agents of others. When there are many masters to serve, it is the master who pays the servant whose interests are most likely placed front and center.

Corporate pension plans, for example, are controlled by the same executives whose compensation is based on the earnings they report to shareholders. During the 1990s, they arbitrarily raised their projections of future pension plan returns, enhancing operating earnings to meet “guidance” targets, even as interest rates tumbled and prospective returns eroded.

Similarly, mutual fund managers are compensated by separate corporations seeking to maximize the return on their own capital (i.e., to enhance their own wealth), in direct conflict with their duty to maximize the returns on the capital entrusted to them by their fund shareholders. The excessive advisory fees, expenses, hefty sales loads, and huge commissions on portfolio transactions paid to brokers in return for their sales support consumed something like 45% of the real returns earned on fund portfolios during the past two decades.

Second, unlike their predecessors in the 1950s and 1960s, today’s financial institutions are now focused on modern investment strategies that emphasize short-term speculation in evanescent stock prices, rather than traditional long-term investing based on durable intrinsic corporate values. From 1950 to 1965, for example, equity mutual funds turned over their portfolios at an average rate of 17% per year; in 1990-2005, the turnover rate averaged 91% per year. The old own-a-stock industry could hardly afford to take for granted effective corporate governance in the interest of shareholders; the new rent-a-stock industry has little reason to care.

To further complicate matters, today’s typical giant private financial institutionâ€”managing both pension plans and mutual fundsâ€”faces serious conflicts in its exercise of the rights and responsibilities of ownership. When a proxy proposal is opposed by the management of a corporate client, the money manager is unlikely to vote in its favor. It is not surprising, then, that, governance activists among large private money managers are conspicuous not merely by their scarcity, but by their absence.

And it gets worse. Today, it is difficult to separate the owners from the owned. Through its defined-benefit pension plans, corporations own 12% of all stocks, and dominate another 11% through defined-contribution savings plans. What is more, most of our largest money managers are themselves now owned by giant financial conglomerates. Arguably, this circularity of ownership allows corporate America to control itself.

The problems created by this new and conflicted world of financial intermediation are hardly trivial. Excessive return projections for pension plans have played a major role in creating the current shortfall of $600 billion private pension plan liabilities relative to plan assets. The shortfall in public plans has been estimated at $1.2 trillion, bringing the total deficit to $1.8 trillion, and rising.

Individual retirement savings are also at dangerously low levels. Only 22% of our workers participate in 401(k) savings plans and only 10% in IRAs. (About 9% have both.) Despite having had a quarter-century-plus to build assets in these tax-sheltered plans, investors have accumulated balances of but $33,600 and $26,900 per participant respectively, a trivial fraction of what would be required for a decent retirement.

With today’s agency society arrogating to itself far too large a share of market returns, the outlook for future individual retirement savings is dire. Consider that a young citizen entering the work force today has an investment horizon of at least 60 years. If, for example, the stock market were to earn an average nominal return of 8% per year, $1,000 invested today would then be worth $101,000â€”the magic of compounding returns.

But if our financial system consumes 2.5 percentage points annually of that total returnâ€”a conservative estimate of today’s realityâ€”that $1,000, growing now at 5.5% net, would be worth just $25,000â€”a minuscule 25% of the accumulation that could have been obtained simply by owning the stock market itself. The magic of compounding returns, it turns out, is simply overwhelmed by the tyranny of compounding costs at today’s exorbitant levels.

The serious shortfalls in retirement reserves that represent the backbone of the nation’s savings have arisen importantly because our manager-agents have placed their own interests ahead of the interests of the investor-principals they are duty-bound to serve. Our financial institutions have failed to exercise the rights and responsibilities of corporate citizenship; to adequately fund pension reserves; and to deliver to fund shareholders their fair share of the returns generated by the financial markets themselves.

Why? Largely because the radical change from an ownership society dominated by individual investors to an intermediation society dominated by professional money managers and corporations has not been accompanied by the development of an ethical, regulatory, and legal environment that requires trustees and fiduciaries, as agents, to act solely and exclusively in the interests of their principals.

In addition, we have developed a whole patchwork of tax-deferred retirement programsâ€"Social Security, corporate and public pensions, deferred compensation plans, 401(k)s, 403(b)s, individual IRAs, and Roth IRAsâ€"and are now considering the addition of Personal Savings Accounts to the list. We need to undertake a careful appraisal of this complex and often costly mix, and work to develop an integrated retirement system that will enhance the nation's savings.

The overarching need is for a clearly enforced public policy that honors the interests of our citizen-investors and puts these beneficiaries in the driver's seat where they belong. It is high time for the appointment of a blue-ribbon federal commission to examine these issues and make appropriate policy recommendations to resolve them. The ownership society is over. The agency (or intermediation) society is not working as it should. We urgently need a truly enlightened fiduciary society. The sooner the better.

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