THE WALL STREET CASINO

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Feverish transaction activity in the stock market has become one of the hallmarks of our great bull market. So far, on every business day of 1999, investors have traded some 1.5 billion shares of stock. The annual turnover rate of shares has risen to a half-century high of 95 percent, closing in on the all-time high of 119 percent recorded in 1929. In 1960, the turnover rate was just 12 percent. Today, the average investor holds a share of stock for but a single year.

The mutual fund industry, guardian of the lion's share of the savings flows of American families, is a vigorous contributor to these new highs in activity. In contrast to the average five- to six-year holding period of the early 1960's, the average fund now holds a portfolio investment for little more than a year. Once characterized as long-term investors, most fund managers can now be fairly described as short-term speculators.

And, taking the cue from their fund managers in the heady market atmosphere of the day, mutual fund investors themselves have become active traders. They now hold their own fund shares, ostensibly purchased to meet long-term goals such as the building of a retirement nest egg, for an average of but three years. Much of this activity takes place in "no-fee" marketplaces for trading fund shares — a serious misnomer, for the assets of the fund shareholders themselves are tapped to pay the bills.

These trends show no sign of abating. Indeed, stock trading over the Internet — one of the principal contributors to the surge in activity — is now said to account for more than 20 percent of all market volume. Breathtaking technology enables investors to trade speculative Internet stocks over the hyperactive Internet stock market simply by pressing a few keys on their computers.

Is all this thrashing around in the stock market productive for investors? Unequivocally, it is not. The returns investors actually earn are inevitably represented by the returns earned in the stock market itself, less the costs investors incur in earning those returns. The market is simply a gambling casino where investors as a whole try vainly to outpace the market. Beating the market is a zero-sum game, but only before costs are deducted. In the stock market casino, it is the croupiers who win.

And there are lots of croupiers, wielding wide rakes. The manager of the average equity fund rakes in annual revenue equal to 1.5 percent of its assets. The fund salesman receives, over time, at least 0.5 percent per year. The brokers who handle the fund's vigorous trading activity collect perhaps another 1 percent. And during the bull market, the Federal Government, the greediest croupier of them all, has been raking in another 3 percent per year from fund investors who pay taxes on the capital gains the fund distributes. Hyperactive funds realize both long-term and short-term gains at a rate that, if nothing else, helps to balance the Federal budget — by an estimated $10 billion of extra taxes in 1998.

Investors are gradually becoming aware of the toll taken by fund costs. Net cash flows into equity funds in 1999 are running 30 percent below 1998 levels. Disenchanted by poor fund returns relative to market averages — largely engendered by high costs — many investors have apparently turned to trading individual stocks on the Internet, where they can manage their own money and execute most trades for $24.95 or less.

This seemingly trivial commission may or may not be a bargain, depending not only on how well the trade is executed, but on how often the investor trades. The croupiers rake in more money as trading activity soars. Being a croupier is where the big money is. Where, indeed, are the customers' yachts or private jets?

The sad fact is that investors today, by incurring all of these costs, are acting directly counter to their own best interests. In the long run, the best way to capture as much of the stock market's return as is possible is to buy and hold stocks and minimize the costs of investing. In this way, investors can capture 98 percent to 99 percent of the market's pre-tax annual return, after the deduction of costs. But mutual fund investors, paying aggregate costs of 2.5 percent per year (excluding taxes), would receive only 75 percent of an annual market return of 10 percent. Active investors in individual stocks seem to do even worse, capturing an estimated 65 percent of the market's return after trading costs.

Extended over time, the negative impact of the compounding of these annual costs is confiscatory. Assume a 10 percent market return over the next 25 years. An initial $10,000, simply invested in the stock market, would grow to $108,300. Now assume investment costs of 2.5 percent and extra taxes of another 1.5 percent. The investor accumulates but $42,900, fully $65,000 less than the market. The investment croupiers rake in 44 percent, and the government croupiers rake in 16 percent. The casinos flourish. But not the investor. Having put up 100 percent of the capital and assumed 100 percent of the risk, the investor would receive barely 40 percent of the return. It is not a good deal.

What do intelligent investors do? First, they realize that the key to investment success lies not in trading pieces of paper on a short-term basis (what most funds do), but in owning shares of businesses and holding them for the long term.

Some may do this by retaining investment managers who emphasize a buy-and-hold strategy. (Warren Buffett's strategy is to buy shares in a small number of large companies, and his favorite holding period is "forever.") Others simply buy their own stocks and hold them for the long term. And still others own index funds that track the stock market, in effect buying a share in every corporation in America and holding it as long as the business exists. By steering clear of the usual croupiers, investors using such strategies have the best possible opportunity to ride out any short-term disappointments and enjoy optimal long-term wealth accumulation.

Today's stock trading frenzy ill serves the investor. It brings to mind Lord Keynes's warning that "when the capital development of a country becomes a byproduct of the activities of a casino, the job is likely to be ill-done." Investors who stay out of the casino and hold stocks for the long term stand the best chance that their own job of capital accumulation will be well done.

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