Economics, Politics, and the Financial Markets

Remarks by

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I guess that it's fair to say that the timing of this gathering is, well, fortuitous. Better, I suppose, that I should speak to you after a 900-point rally in the Dow Jones average than speak to you just a few days ago, after a precipitous seven day decline of 2400 points, the culmination of a 40 percent decline from last October's high.

But this evening comes not only in the midst of infinite turmoil in the financial markets, but at the confluence of profound economic challenges (the global banking crisis, the collapse in home prices, and the onset of recession), and the portent of profound political change (our presidential election is exactly three weeks away).

One might think that this turmoil has captured the rapt attention—and deep concern—of the American public. But one might be wrong, too. Here, for example, are the hottest searches on NYTimes.com during the week of September 28-October 4.

Steve Fossett
Elisabeth Hasselbeck
FDIC's failed bank list
Heather Locklear
Guitars for sale
Angelina Jolie

Elisabeth Hasselbeck news (That's twice!)

Bailout bill

Vice presidential debate

Nothing at all about economics; the only political search was the vice presidential debate; and the FDIC failed bank list (I guess readers were worried about their savings) and the bailout of Wall Street were the only searches related to the financial markets. (Confession: I have absolutely no idea of who Elisabeth Hasselbeck and Heather Locklear are.)

But I imagine that you friends of Blair Academy who have honored me with your presence this evening are here because you are indeed interested in the three topics of discussion on our agenda. Since the dramatic daily fluctuations of the stock market, however meaningless in the long-run—I have described them, after Shakespeare, as "a tale told by an idiot, full of sound and fury, signifying nothing"—tend to command our attention, I propose to begin with some much needed perspective on what investing is all about.

I do so by quoting from my second book, *Common Sense on Mutual Funds, New Imperatives for the Intelligent Investor*, published almost a *full decade ago*.

> Investing is an act of faith. We entrust our capital to corporate stewards in the faith—at least with the hope—that their efforts will generate high rates of return on our investments. When we purchase corporate America's stocks and bonds, we are professing our faith that the long-term success of the U.S. economy and the nation's financial markets will continue in the future.
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> When we invest in a mutual fund, we are expressing our faith that the professional managers of the fund will be vigilant stewards of the assets we entrust to them. We are also recognizing the value of diversification by spreading our investments over a large number of stocks and bonds. A diversified portfolio minimizes the risk inherent in owning any individual security by shifting that risk to the level of the stock and bond markets.
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> Kindled by bull markets and chilled by bear markets, Americans' faith in investing has waxed and waned, but it has remained intact. It has survived the Great Depression, two world wars, the rise and fall of Communism, and a

> barrage of unnerving changes: booms and bankruptcies, inflation and deflation, shocks in commodity prices, the revolution in information technology, and the globalization of financial markets. In recent years, our faith has been enhanced—perhaps excessively so—by the bull market in stocks that began in 1982 and has accelerated, without significant interruption, toward the 20th century's end. As we approach the millennium, confidence in equities is at an all-time high.
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> Might some unforeseeable economic shock trigger another depression so severe that it would destroy our faith in the promise of investing? Perhaps. Excessive confidence in smooth seas can blind us to the risk of storms. History is replete with episodes in which the enthusiasm of investors has driven equity prices to—and even beyond—the point at which they are swept into a *whirlwind of speculation*, leading to unexpected loses. There is little certainty in investing. As long-term investors, however, we cannot afford to let the apocalyptic possibilities frighten us away from the markets. For without risk, there is no return.

As you might suspect, then, even these ten years later, I wouldn't change a word that I then wrote. For investing is all about buying businesses—real operating companies, making real goods and providing real services for real consumers who use the goods and services in their daily lives; real companies that are operated by real managers and staffed by real workers, with real strategies; earning real net income and plowing some of it back into real capital goods and distributing what remains to the owners in the form of, yes, real dividends. Let's call this the *real* capitalism.

In the long run, it is the returns earned by businesses that create value for investors. For example, over the past 100-years, the return on stocks has averaged 9 ½ percent per year—4 ½ percent from dividend yields and 5 percent from earnings growth.

Speculation can—and does!—raise or lower this total investment return during interim periods. For example, the price that investors paid for each dollar of earnings on stocks in 1980 soared from $8 (a p/e ratio of 8 times) and to $32 (32 times earnings) in early 2000—adding, on average, an amazing total of some 7 percentage points per year to investment return in the greatest bull market of all time.

But in the very long run, speculative returns account for nothing—zero. Speculation simply reflects the optimism or pessimism—the hopes and fears—of the mass of investors, reflected in the "expectations market" rather than garnered through the stern arithmetic of the "real market" of investment returns—authentic earnings growth and dividend yields.

In this sense, as I wrote in my 2007 book *The Little Book of Common Sense Investing*, "the stock market is a giant distraction to the business of investing." Of course it is!

But the market is more than a mere distraction. It is an *expensive* distraction. For it must be obvious that all investors as a group exactly capture the market's return. If stocks return 8 percent, we earn a gross return of 8 percent. But only before the costs of our investment system are deducted, say about 2 percent per year. After these costs, our net return drops to 6 percent. "Gross return minus cost equals net return." What else is new?

So, those who *invest* in business—buying and holding a diversified list of stocks that may encompass the entire U.S. stock market (yes, I'm speaking of the index fund)—capture virtually the entire return of the market. Those who *speculate* on stock prices, on the other hand, lose to the market by the amount of "croupier costs" they incur. (My choice of this gambling term is deliberate; speculating on whether the momentary price of a stock will rise or fall is, simply put, gambling.)

So we must have a lot more investors than speculators in our markets, right? Wrong! During the recent era—right up to this very day—the wisdom of long term investing has been overwhelmed by the folly of short-term speculation.—an orgy of speculation the likes of which has never been seen before.

It's true! During the then-record speculation of 1929, for example, annual turnover of stocks reached a record level of 145 percent. When I came into this business all those years ago (the ancient 1950s), turnover had returned to a more normal level of about 30 percent annually. But by last year, turnover had soared to 280 percent, and this year it is on track to exceed 325 percent—great news for the financial sector, the brokers, the investment bankers, and the money managers; but terrible news for investors.

One result of this crazy speculation—you all must know this by now—has been the unprecedented market turbulence I have described. A simple measure makes the point: During my first few decades in this business, we might have three or four days each year in which stocks rose or fell by two percent or more. Since July 2007, however, stocks have risen or fallen by that amount on 52 days, 21 up and 31 down—volatility without precedent in all history.

But does this market craziness reflect *reality*? No it doesn't. Since the October 2007 high, the total capitalization of the U.S. stock market has crashed from about $18 trillion to $10 trillion, at the low last Friday, a drop of some $8 trillion. But that's "the market." Does anyone here tonight really believe that the value of American corporate *business* in the aggregate has dropped by $8 trillion—by 40 percent! Well, I for one do not. Over the entire modern era, U.S. business has grown, with remarkably few interruptions, (for example the Great Depression), at about the pace of the real economy.

Much of the responsibility for the crash in prices can be laid on Wall Street. Investment bankers, brokers, and money managers shifted their attention away from honoring, first and foremost, the interests of their clients and toward increasing their personal wealth and the earnings of their (largely publicly held) firms. Their creation and promotion of infinitely complex credit instruments (often debt obligations collateralized by mortgages, known as CDOs) led to the mass marketing of mortgages of dubious creditworthiness bundled in packages. In addition, an enormous system of betting on whether these bonds would or would not default (using "credit default swaps," or CDS) emerged, and spread its tentacles to financial institutions all over the globe. The notional value of CDS market—gambling on a bank's creditworthiness—now totals an astonishing $62 trillion.

Now the CDS is merely a way to speculate on whether a bond will default or not. Investors pay an insurance premium to bet "yes" or "no," and the premium varies with how speculators regard the likelihood of default. Simple enough, until your realize that that $62 trillion is being bet on only $2 trillion of underlying bonds. Talk about gambling!

A homely comparison: Let's say you insure your house with $700,000 of fire insurance. Then, 62 of your neighbors bet that it *will* burn down, and 62 other neighbors take the other side, betting that it *won't*. You might say, "what's wrong with that", to which I'd respond, "just watch out for arsonists." That proves to be a problem in the CDS market, as speculators make huge bets—*sub rosa*, opaque, unreported—and with no idea whether the neighbor, as it were, on the other side of the bet (the "counterparty") has the wherewithal to make good.

But there is another far more subtle force that has played a huge role in the orgy of speculation that has affected our fiscal markets. During the past half-century, the very nature of capitalism has undergone a pathological mutation. We have moved from an *ownership society* in which 92 percent of stocks were held by individual investors looking after their own interests and only 8 percent by financial institutions, to an *agency society* in which our institutions now hold 76 percent of stocks and individuals hold but 24 percent.

It is these agents who have been the driving force in changing the central characteristic of market participation from *long-term investment*—owning businesses that earn a return on their capital, creating value by reinvesting their earnings and distributing dividends to their owners—to *short-term speculation*, essentially trading stocks and betting on their future prices. It is not only hedge funds that are playing this game, but most mutual funds and many giant pension plans. These institutional agents have not only abandoned their traditional investment *principles*, but also betrayed the interests of the *principals* to whom they owe a duty of trusteeship.

But Wall Street marketers and entrepreneurs loved this new system of complex products, quantification, innovation, and unconstrained risk, ignoring its destruction of their clients' wealth and wallowing in the wealth it generated for themselves. Revenues of our stock brokerage firms, money managers, and the other insiders soared from an estimated $60 billion in 1990 to some $600 billion in 2007.

For the outsiders—the market participants as a group, who inevitably feed at the bottom of the food chain of investing—that enormous sum represents a truly staggering hit to their earlier gains in the bull market, and a slap in their face in the bear market that followed. Any confidence in Wall Street that these participants once may have had has largely vanished, just as it should have.

Of course, the speculators among us, and those of us who have forgotten the distinction between investment and speculation—two groups that inevitably display a large amount of greed—must share a portion of the responsibility for the financial bubble and the ensuing crash. But it is up to Wall Street to lead the way to restoring the confidence of investors; even more, to move the financial sector away from the extraordinary popular delusions of today's crowds and the madness of today's speculators, returning to the wisdom of long-term investing.

The financial crisis, which took a decade or more to reach full fruition, has now spread into the real economy of business and commerce, of consumers and families. There is little that can be done except to work out the problems over time, and to hope that our Federal government is successful in freeing up the credit markets and relieving—at a staggering cost to taxpayers—the banks of the responsibility for their foray into speculation and their embrace of the toxic securities that now crowd their balance sheets. This economic process will take some years to restore itself.

The need to restore confidence in Wall Street goes beyond the financial sector, and indeed beyond the real economy in which each of our citizens has a stake. We need to return capitalism to its traditional roots as a system focused on long-term investing, not short-term speculation. For as the great British economist John Maynard Keynes reminded us more then 70 years ago, words I cited in my Princeton University thesis in 1951, and most recently in my newest book (out in 2 weeks), *Enough. The True Measures of Money, Business, and Life.* "When investment becomes a mere bubble on a whirlpool of speculation, the job of capitalism will be ill done."

Especially at this dire time, that is the one thing that our nation cannot afford.