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CAPITAL MARKETS TODAY AND TOMORROW

An Address by

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Over the years I have attended many luncheons of this club for pleasure and profit. I have heard so many splendid talks by so many men of ability that my gratification at being asked to speak to you today is mixed with certain feelings of inadequacy. It is much easier to sound off as a bureaucratic know-it-all when you are a safe distance from home.

You haven't made it any easier by giving me such a hard act to follow. The areas of my official concern, and about which I intend to speak, can hardly match in excitement and immediate importance the subjects that you discussed with the President a week ago.

During this period of Constitutional crisis I am among the many in Washington whose mission it is to keep the government operating effectively for the general benefit of us all. While the problems that most of us face are many and difficult of solution – and in that sense our jobs are hard – this is not on the whole a bad time to be in Washington. In fact, in many respects, it is a surprisingly good time.

I read occasional reports in the press to the effect that much of the government has come to a virtual halt because of lack of direction and unwillingness of officials to accept responsibility, make decisions and adopt needed new programs. Naturally I cannot speak for the entire federal government. I can only say that those portions to which I have been directly exposed do not exhibit any such symptoms of paralysis. Nor have I seen any unusual reluctance of good men to come to Washington and help out.

On the contrary, to the extent that I am familiar with the persons involved, I think our President has been wise in his appointments, and it is clear that good people are willing to accept. I mention this only because I think we have enough real problems facing us today without increasing them with anxiety that we are without an effective government. From my observation, this is simply not the case.

One reason it is not the case is Chicago's own outstanding contribution to effective government in the person of Secretary of the Treasury George Schultz. No one more richly deserves the opportunity to retire from public life, if he so chooses, as he evidently does. He has given his full measure of devotion many times over in a variety of positions of top importance. He is certainly entitled to a rest and relief from constant public scrutiny, but he will be sorely missed. Both the City and University of Chicago should be most proud of him. I hope he returns permanently to our community.

The subject most on my mind these days – when I'm not worrying about our budget – or whether we can get more office space – is the state of our capital markets and what we can do about them. Some of the problems with our markets are quite technical, and I realize that most of you are not technicians in this regard, but the subject is important, nevertheless, and I would like to explain what it is all about, at least in broad terms.

It should not be necessary to belabor with you people the proposition that we are all involved with our capital markets, directly or indirectly, in one way or another. Pension funds are today on the whole heavily invested in common stocks and other equity securities which, to a far greater extent than bonds, depend largely on the stock markets and marketability for their value. It has been observed by some that reliance on these funds for old age protection is now so widespread that any major collapse in these values, to the point where obligations would not be met, would not just produce disappointment. It would produce a new society. This tends to give a new dimension to the social reliance on our stock markets.

Of course, in addition to pension and other retirement and profit-sharing funds, an important segment of our population hold marketable securities directly, or benefit from them indirectly through mutual fund shares or participation in various types of trusts or mutual or participating insurance policies.

And there is the other side of the market. In broad economic terms, we must be concerned equally, if not more, with the ability of our companies to raise capital, especially equity capital. While this is a constant factor in any growing economy, there are many indications that we are on the threashold of a period of extraordinary demands for new capital. The estimates one hears of the size of this demand are staggering. For instance, a prominent banker who is expert in the field has estimated the capital needs of the energy industry for the coming decade as in excess of $1.3 trillion. The electric utility industry has been estimated as needing at least $61 billion in the next 3 or 4 years. AT&T alone has announced a capital investment program of $1 trillion for the coming years. It does not matter how accurate these estimates turn out to be if they are generally correct in order of magnitude, and in that respect, there is no reason to doubt them.

Naturally, all of this new capital demand will not have to come from the issuance of new common stock, but a substantial portion must. We know now that there is an unquantified but large and growing demand for new equity capital among industrial companies generally. Many companies are in a position where they cannot grow indefinitely from the reinvestment of retained earnings and borrowings. The time is coming or now is when further growth requires selling more stock. Under today's conditions company management may be told by investment bankers that, even if they are prepared to bite the bullet and sell stock at 4 or 5 times earnings, the market just isn't there. This deal isn't "do-able". These conditions especially cripple newer companies who are capable of rapid expansion if they can get the necessary capital.

I realize that there is sentiment abroad, and perhaps growing, to the effect of "Who cares?" We are already wasting our non-replaceable natural resources at a shameless rate and cluttering up our little space craft with too much unnecessary junk – as the argument goes. Now, I am not so short-sighted as to miss the point of the zero economic growth movement. Obviously, our present economy cannot continue as it is today forever, much less continue to grow exponentially, but simply to extrapolate from the last 25 years to the next 25 is to deny our science and resourcefulness. Furthermore, whatever adjustments prove necessary to the exhaustion of natural raw materials and the environmental effects of our present activities cannot, in my opinion, be successfully met simply by stopping growth now.

In this respect, as in most respects, I agree with Professor Lorie of the University of Chicago in his report to Secretary Schultz on "Public Policy for American Capital Markets", where he observes:

> It is fashionable in some quarters to decry economic growth on the grounds that we are sufficiently affluent and that growth requires hard work and causes pollution. At the same time, we are concerned about the levels of income of many of our citizens, about the plight of our cities, about health facilities and needs for medical research, and about many other social problems which rely on economic resources for their amelioration.

The weariness with affluence that leads some of our suburban youngsters to decry shabby money-grubbing and glorify the moral superiority of poverty is simply not shared by the millions of our people who have known only the grinding misery of being poor and seek desperately for the chance to spoil their kids with steak and Cadillacs before the game is called. For the next decade, at least, it seems clear to me that economic growth is highly desirable if it is not, indeed, a social imperative.

With these thoughts in mind, what is wrong with our capital markets, and what can we do about it? Well, the most obvious thing that seems the most wrong is that prices are down. Why are they down? We SEC commissioners, by Act of Congress, are experts on many things, but Congress has wisely declined to declare us experts on the value of stocks. And my predessors have wisely refrained from expressing opinions on the subject for fear that, because of our official positions, our personal notions will be given far more weight than they deserve. It is, for example, basic to the philosophy of the Securities Act that in permitting stock registered under the Act to be offered to the public, the Commission is expressing no opinion on the merits of the investment, including the price. In fact, it is a criminal offense to represent otherwise, and a big, bold legend on the cover of every prospectus filed with us so states.

I gladly adhere to this tradition. I express no opinion on whether stocks are worth more than people are presently willing to pay for them, and I express no opinion on when or whether prices generally will go up or down. Nevertheless, I think I can with official propriety observe that many things would be better if prices were higher and more people were interested in buying.

The reasons that prices are down and volume of trading is down and individuals in particular seem in large numbers to have lost interest in our stock market are surely manifold. Some say that a lot of people lost a lot of money in the last four years and they are still mad about it and one need look no further. Some say that everything can be explained by the stepped-up rate of inflation and abnormally high interest rates.

Both of these factors are surely important. As to the latter, some European financial men have told me that they learned long ago that common stocks may be a good hedge against mild inflation but not when inflation hits the rate we have been experiencing lately, or not when interest rates tend to match the inflation rate.

I have other explanations, as do you. Some say that the rate of total return – dividends plus growth in price – on stocks generally must exceed interest rates by several points. So when interest rates go up, stock prices go down. Others attribute the lack of stock invested by individuals to the growth of pension plans, company supplied medical insurance, and other such plans and fringe benefits – all encouraged by our tax policy. This argument says that fewer and fewer persons today have to save and invest to protect themselves from disaster and old age. This is done for them, so any loose cash available for investing is money to play with. Right now it is more fun to play with real estate, silver, Scotch whisky, tax-sheltered oil drilling or cattle-feeding programs and the like.

I am reasonably certain that each of these observations has validity but none has exclusive validity. They have one characteristic in common. Each refers to matters wholly beyond our jurisdiction and competence. We cannot prevent market losses, and we are not about to propose solutions to inflation or to oppose retirement and other benefits of great value and comfort to the recipients. To the extent that these factors govern our markets, our program is to watch and pray.

There are, however, other apparently contributing factors that come closer, at least, to our neighborhood. Consider, for example, what many refer to as the institutional problem. It is a fact that so-called institutional investors – pension plans, mutual funds and the like – play a far greater role in our stock markets today than in the past. The frequently quoted statistic is that within the last decade or so the percentage of shares traded on the New York Stock Exchange accounted for by institutions has risen from 30% to 70%. Much of this increase is doubtless attributable to the change in policy for portfolio management of pension funds from a largely actuarial basis to one of performance, aimed at reducing the annual contribution required of employers. The pattern during this period in this area moved from roughly 80% fixed income and 20%

equities to the reverse. A similar total return concept took hold in the management of many endowment portfolios.

But what is so bad about institutional participation in the stock markets? One cannot reasonably say that it is bad for institutions to be in the markets, but their tendency to dominate does present some problems – for them as well as for others. The problems stem from the fact that it is uneconomical and inefficient for the manager of a large fund to invest small sums of money in a multitude of stocks.

When they decide to invest in a given stock, they tend to want a lot of it, and when they decide to sell, to sell it all. This leads to transactions in large blocks of several hundreds of thousands of dollars or more that cannot be accommodated by the normal specialist system of the exchanges. While devices have been developed for handling these blocks, they may produce disruptive effects on the reported market price of the stock, to the detriment of their investors. This is especially true if several large institutions all decide to unload large blocks at about the same time.

There has been much said about the vulnerability of the individual investor to sudden drops in the value of his stock caused by mass institutional selling which he is unaware of until all of the damage has been done. To provide individuals some comfort and protection in this regard, we have formed legislation that would at least require managers of pension funds and other large portfolios above a certain size to report publicly what securities they hold quarterly or at other reasonable intervals. That would not warn the individual when an institution was going to sell, but it would inform him of the institutional involvement in a particular stock.

Senator Bentsen, of Texas, has gone a bit further in a bill that he has introduced. He would restrict the percentage of pension funds under common investment management that could be invested in any one stock to 5%. We have not been asked to comment on that bill, but one cannot help but observe that 5% of $100 million, for example, is still $5 million, which is a pretty big block. We are inclined to the position that a better solution, in addition to portfolio disclosure from time to time, is better facilities for handling block trades plus provisions requiring that individual investors who have placed orders at an appropriate price be permitted to participate in the block transaction.

A charge of another nature against institutions is that they are soaking up too much of the money otherwise available for investment in stocks, and that in their own investments they concentrate on a limited number of current favorites, leaving too little available for investment in the stocks of other companies. This also lies behind Senator Bentsen's proposal for forced diversification plus his proposal to relax the so-called prudent man standard for a small percentage of a pension fund portfolio to encourage investment in small, growing companies. I should say, in fairness, that the managers of major trust departments have denied the validity of either of these reasons for intruding on their portfolio management.

It is said that institutions also get material inside information from companies that either is not made available to individual investors or is made available too late. To the extent that this occurs, it is a violation of the federal securities laws, and if we discover it, we bring actions. We hope that we have brought enough actions so that this is not a major cause for concern. There are, however, certain facts of life we cannot change that do give some advantage to the full-time professional manager over the individual who has to spend his days in other occupations. Nevertheless, we are constantly striving for improved rules and practices to get more meaningful information more widely distributed so as to give the individual investor prompt access, at least, to all of the facts material to his investment decisions.

Five years or so ago the securities industry suffered a major disaster from what might otherwise be thought of as an embarrassment of riches. The volume of trading got so far ahead of the ability of the broker-dealers and the corporate transfer agents to handle it that severe financial distress was caused in many quarters. What the industry calls “fails,” meaning failures by a selling broker to deliver certificates for the shares sold to the buyer’s broker on time, became so widespread that for this, and other, reasons over 100 broker-dealer firms became insolvent. Among other things, they were too thinly capitalized to carry through under the circumstances. Only by heroic measures of the New York Stock Exchange and others was a more damaging widespread collapse avoided. One result of it all was to create come distrust of brokerage firms and a reluctance to leave securities or cash in their possession.

We believe that substantial progress has been made in this area. Customers accounts are now insured up to $50,000 by the Securities Investors Protection Corporation created by the Congress in 197 and other important measures have been taken by the stock exchanges and the National Association of Securities Dealers as well as the SEC to guard against financial failure by brokers and losses by customers if failure should occur.

In addition, important developments are in progress which will make the entire process of handling securities transactions more efficient, at lesser cost, and less susceptible to collapse in the face of sudden increases in volume. The brokerage firms themselves are investing substantial sums in modern computerized facilities, and there are in progress arrangements for nationwide clearance and the placing of securities in depositories, and other methods, to eliminate the costly and unnecessary shipping of paper back and forth across town and across the country.

These measures, plus the program for a central market system, that will provide a modern communications network to tie in all markets for widely-held stocks - - to the benefit of both institutions and investors - - are all headed toward the best and most efficient capital market system within the capability of modern technology.

Our aim, and that of the several industry groups working with us, is to establish the most efficient market system feasible, one that will provide adequate liquidity for institutional investors and at the same time be fair and reliable for the individual investor.

We want institutions to have maximum marketability for their large holdings and we want the individual to feel confident in his broker and confident that he will be treated fairly, especially in relation to the big fellows - - the institutions - - and that he is charged only a reasonable sum related to the cost of the services he wants. I am confident that all of this can and will be done. Of course, the best capital market system imaginable will not curb inflation or guarantee every investor a handsome gain, but we hope that it will contribute to a resurgence of confidence and help provide the huge sums of capital that our industries are going to need.

A healthy capital market, however, requires something more than a fair and efficient market system. It also requires financially healthy members of the securities industry to service the system. Financial health requires profitable operations and adequate capital. Naturally, the two go together. At the moment, capital in the industry is declining, which threatens the liquidity of large institutional blocks and the availability of adequate underwriting capacity.

It may be that these problems can only really be solved by rising market prices and sustained increases in the volume of trading. The industry has invested so much in modern facilities for handling transactions that it now finds itself with a much higher fixed cost base and its profits or losses more sensitive than ever to swings in volume. The New York Stock Exchange estimates today that it takes daily trading volume in excess of 17 million shares for its members as a whole to break even. It wasn't very long ago that such volume seemed fantastic.

The securities industry has certain other peculiarities. Its fixed commission rate structure and methods of compensating salesmen have in the past led to rather wild swings in personal income. Five years ago young hot shots a few years out of B school were receiving absurd amounts of money for doing very little and they suddenly found it impossible to keep up the payments on the fancy homes and yachts. The experience was not good for them and it did not generate respect, still less sympathy, among others. But the principals, the partners or stockholders of the firms did not, in large measure, behave with much more foresight. For historical and tax reasons, a virtually 100% payout of annual earnings was quite common.

As usual, it is easier to point out these weaknesses than it is to offer remedies. However, despite the fears of many broker-dealers about the consequences of fully competitive commission rates, I am hopeful that the greater freedom this will permit to management will enable them to find means of charging for services that reduce the heavy dependence upon volume related transaction charges, producing a steadier flow of revenues to meet higher fixed charges.

As Professor Lorie suggested, there are also helpful changes that should be considered in federal income tax policy. It would greatly help the long-range financial stability of securities firms to permit bank-type reserves for losses, to encourage rather than discourage the retention of earnings, when there are earnings, and to encourage persons to invest in firms by way of preferred stock and subordinated loans without risking adverse tax consequences.

Many countervailing factors must be weighed in determining tax policy, as it is outside our area of official concern, but I, at least, hope that sympathetic consideration will soon be given to Professor Lorie's suggestions.

It may also be that brokers suffer in popular esteem because they are associated with market losses in recent years - - suffering the fate of the messenger of bad news. But this is not a time when we can let emotional immaturity govern our treatment of the securities industry. Present conditions are revealing its essential role in a free economy and a free and competitive capital market system. The industry needs and is getting restructuring and modernization to increase its fairness and efficiency. It also needs sympathetic treatment from the government to help it solve its servere capital problems.

In conclusion, let me quote once more from Professor Lorie's report.

> The overriding objective of public policy is to make our capital markets function more equitably and efficiently so as to reduce the cost of capital for American enterprise and increase the likelihood that capital will be channeled into its most productive uses. This objective can be fostered by insuring that our securities markets operate to achieve maximum efficiency in determining prices of securities and in effecting the transfer of ownership of securities. Moreover, attainment of this public policy objective requires the achievement of equity in relationships between investors and their financial agents, as well as between individual investors and institutional investors.

If you add to these the financial stability and reasonable profitability of the securities industry, you have a fine statement of our policy and goals with respect to our capital markets.