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JANUARY 23, 1990

THE HONORABLE MICKEY EDWARDS
HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

RE: MARKET VOLATILITY

Dear Mr. Edwards:

I believe that the extreme volatility of the financial markets over the last few years is one of the most significant economic problems facing our country. The small and medium sized investors are the life blood of the markets and they are being driven out by fear of the apparent instability. As they leave the markets as direct participants, they also cease to feel involved and become adversaries rather than supporters of economic progress and freedom.

I have enclosed a copy of my memorandum entitled "MARKET VOLATILITY vs THE AMERICAN DREAM" which covers my opinions as to the major causes of excess market volatility and the ultimate result of a failure to bring it under control.

For the reasons described in the memo, I strongly urge you to use your efforts to eliminate exchange trading of the purely speculative Financial Index Futures and Options contracts and to support a reinstatement of the long-term capital gains tax rate.

I hope that you find these opinions interesting and useful.

Sincerely yours,

JW Moore

MARKET VOLATILITY vs THE AMERICAN DREAM

J. W. Moore

The American stock market is the greatest system yet devised to accumulate the capital to fuel economic expansion and has served this purpose well for over 100 years. It allows the 'Little Guy' to participate right along with the 'Giants Of Industry' as they collectively search for The American Dream. However, over the last few years the unusual and extreme volatility of the market has been scaring many small investors (and some larger ones) away.

Much has been written and broadcast which lays the blame for this excess volatility on "Program Trading". Although Program Trading is certainly a factor, I believe that it is a symptom, not a cause. It seems to be the same old excuse that "You should have had your check, but THE COMPUTER FOULED IT UP." Arbitrage transactions have always been with us and will be here as long as there are related markets and people who are smart and courageous enough to take advantage of temporary divergences and make a profit while helping to bring the various factors back into balance. Modern technology just allows them to do it better. In addition, I don't believe that there is any practical way to control or eliminate the practice, and I'm not sure that elimination would be a valid objective even if it were possible.

I believe that the underlying problem is the nature of Index Futures contracts themselves and the related Option contracts. They have low margin requirements but are not like normal commodity futures contracts which call for the delivery and acceptance of a specific product (such as a bushel of corn or even a share of AT&T stock) at a specified price on a specified date. Index futures don't add to the orderly flow of goods or services, the stabilization of market prices, or the accumulation and distribution of capital. They are designed to settle in cash and basically represent a gambling game for short term speculators, which, like most gambling games, provide most of the profits for those who operate the games. I have nothing against gambling; however, I believe that it should be done in places like Las Vegas, Atlantic City or at one of the race tracks, not in the financial markets which drive our entire economy.

As more and more speculators enter the Index Futures and Options game, they create larger and more frequent divergences for the arbitragers to take advantages of and cause greater and greater swings of the pendulum, constantly whipsawing the legitimate investor. Occasionally, such as in the summer of 1987 and October of both 1987 and 1989, the activities of the speculators and the arbitragers don't offset and correct but feed on each other to create a runaway situation, in one direction or the other. (It's funny that nobody seems to object when the practice is driving the markets UP to unreasonable and unsustainable levels, but everyone objects when they inevitably come back down.)

I think the first step to reduce unnatural volatility would be to eliminate exchange trading of all futures and options contracts which are designed to settle in cash, thus eliminating the index contracts and program trading, as well as reducing the speculative influence on the markets. Simultaneously, it would help to make the margin requirements for all financial futures approximate the margin requirements of the underlying securities.

Another major cause of increased volatility was the elimination of the long term capital gains tax benefit. The special tax provisions were originally designed to encourage individuals to be investors in the American economy rather than in and out traders. The change in the tax law eliminated the stabilizing influence which made it more advantageous to hold on through small or temporary downturns rather than jumping out and forfeiting the tax benefit. I wonder how many of the shares that were dumped on October 19, 1987 had been purchased during the high volume run up that summer, and how many owners would have been reluctant to dump (and feed the crash) if they had known they were going to lose their tax benefit? Long term investing is a habit, just like short term trading is a habit. The old tax rules encouraged stock purchasers to be investors, and without that incentive, we are becoming a nation of day traders.

The dominance of the markets by institutional investors which has come about over the last few years is still another factor contributing to market volatility. I believe today's professional money managers are the greatest collection of herd animals since the demise of the American buffalo. The creation of the Mutual Fund was a great accomplishment in that it allowed the small or unsophisticated investor to simultaneously obtain a diversified portfolio and the services of a team of professionals to manage it for him. As the number of funds and the competition between them has grown, a whole new breed of segment and switch funds has developed. In order to show the best possible short term result, and beat out the competition, the managers have made the small investor into more and more of a short term trader, even though he buys and holds the fund.

Competition from the Japanese, Western Europeans and others is vividly demonstrating the inadequacy of our antiquated manufacturing plants to compete in the world markets. In order for the United States to again assume the role as the leader of the industrial world, we will have to make massive capital expenditures to modernize our plants and equipment as well as on research, development, technology, and training of our work force. Our productivity level will have to be increased, not only to maintain our standard of living but to care for our increasing number of elderly and to repair our rapidly deteriorating infrastructure of streets, roads, sewers, water supplies, and power plants and to do so in a way that will protect our environment sufficiently to allow life as we know it to continue.

The necessary capital will have to be provided by our financial markets, and they cannot perform unless they are viable and attractive to large and small prospective investors both here and abroad. If the markets dry up, the dream will end.