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Acknowledgments

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After earning my MBA at Harvard, I was faced with several exciting career choices. The unconventional offer to join a start-up investment-management firm in Cambridge, Massachusetts, presented the opportunity to begin building an investment track record early in my career. And so it was that I joined Bill Poorvu, Isaac Auerbach, Jordan Baruch, Howard Stevenson, and Jo-An Bosworth in forming the Baupost Group. Each of my colleagues—Howard in particular—went out on a long, thin limb to bet on me and my abilities, not only to manage their own money but also that of their families and close friends, which was perhaps the greater act of faith. It has been my great privilege to be associated with such knowledgeable, energetic, warm, and caring people. Together we have built something to be proud of.

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Introduction

Investors adopt many different approaches that offer little or no real prospect of long-term success and considerable chance of substantial economic loss. Many are not coherent investment programs at all but instead resemble speculation or outright gambling. Investors are frequently lured by the prospect of quick and easy gain and fall victim to the many fads of Wall Street. My goals in writing this book are twofold. In the first section I identify many of the pitfalls that face investors. By highlighting where so many go wrong, I hope to help investors learn to avoid these losing strategies.

For the remainder of the book I recommend one particular path for investors to follow—a value-investment philosophy. Value investing, the strategy of investing in securities trading at an appreciable discount from underlying value, has a long history of delivering excellent investment results with very limited downside risk. This book explains the philosophy of value investing and, perhaps more importantly, the logic behind it in an attempt to demonstrate why it succeeds while other approaches fail.

I have chosen to begin this book, not with a discussion of what value investors do right, but with an assessment of where other investors go wrong, for many more investors lose their way along the road to investment success than reach their destination. It is easy to stray but a continuous effort to remain disci-

plined. Avoiding where others go wrong is an important step in achieving investment success. In fact, it almost ensures it.

You may be wondering, as several of my friends have, why I would write a book that could encourage more people to become value investors. Don't I run the risk of encouraging increased competition, thereby reducing my own investment returns? Perhaps, but I do not believe this will happen. For one thing, value investing is not being discussed here for the first time. While I have tried to build the case for it somewhat differently from my predecessors and while my precise philosophy may vary from that of other value investors, a number of these views have been expressed before, notably by Benjamin Graham and David Dodd, who more than fifty years ago wrote *Security Analysis*, regarded by many as the bible of value investing. That single work has illuminated the way for generations of value investors. More recently Graham wrote *The Intelligent Investor*, a less academic description of the value-investment process. Warren Buffett, the chairman of Berkshire Hathaway, Inc., and a student of Graham, is regarded as today's most successful value investor. He has written countless articles and shareholder and partnership letters that together articulate his value-investment philosophy coherently and brilliantly. Investors who have failed to heed such wise counsel are unlikely to listen to me.

The truth is, I am pained by the disastrous investment results experienced by great numbers of unsophisticated or undisciplined investors. If I can persuade just a few of them to avoid dangerous investment strategies and adopt sound ones that are designed to preserve and maintain their hard-earned capital, I will be satisfied. If I should have a wider influence on investor behavior, then I would gladly pay the price of a modest diminution in my own investment returns.

In any event this book alone will not turn anyone into a successful value investor. Value investing requires a great deal of hard work, unusually strict discipline, and a long-term investment horizon. Few are willing and able to devote sufficient time

and effort to become value investors, and only a fraction of those have the proper mind-set to succeed.

This book most certainly does not provide a surefire formula for investment success. There is, of course, no such formula. Rather this book is a blueprint that, if carefully followed, offers a good possibility of investment success with limited risk. I believe this is as much as investors can reasonably hope for.

Ideally this will be considered, not a book about investing, but a book about thinking about investing. Like most eighth-grade algebra students, some investors memorize a few formulas or rules and superficially appear competent but do not really understand what they are doing. To achieve long-term success over many financial market and economic cycles, observing a few rules is not enough. Too many things change too quickly in the investment world for that approach to succeed. It is necessary instead to understand the rationale behind the rules in order to appreciate why they work when they do and don't when they don't. I could simply assert that value investing works, but I hope to show you *why* it works and why most other approaches do not.

If interplanetary visitors landed on Earth and examined the workings of our financial markets and the behavior of financial-market participants, they would no doubt question the intelligence of the planet's inhabitants. Wall Street, the financial marketplace where capital is allocated worldwide, is in many ways just a gigantic casino. The recipient of up-front fees on every transaction, Wall Street clearly is more concerned with the volume of activity than its economic utility. Pension and endowment funds responsible for the security and enhancement of long-term retirement, educational, and philanthropic resources employ investment managers who frenetically trade long-term securities on a very short-term basis, each trying to outguess and consequently outperform others doing the same thing. In addition, hundreds of billions of dollars are invested in virtual or complete ignorance of underlying business fundamentals, often using indexing strategies designed to avoid sig-

nificant underperformance at the cost of assured mediocrity.

Individual and institutional investors alike frequently demonstrate an inability to make long-term investment decisions based on business fundamentals. There are a number of reasons for this: among them the performance pressures faced by institutional investors, the compensation structure of Wall Street, and the frenzied atmosphere of the financial markets. As a result, investors, particularly institutional investors, become enmeshed in a short-term relative-performance derby, whereby temporary price fluctuations become the dominant focus. Relative-performance-oriented investors, already focused on short-term returns, frequently are attracted to the latest market fads as a source of superior relative performance. The temptation of making a fast buck is great, and many investors find it difficult to fight the crowd.

Investors are sometimes their own worst enemies. When prices are generally rising, for example, greed leads investors to speculate, to make substantial, high-risk bets based upon optimistic predictions, and to focus on return while ignoring risk. At the other end of the emotional spectrum, when prices are generally falling, fear of loss causes investors to focus solely on the possibility of continued price declines to the exclusion of investment fundamentals. Regardless of the market environment, many investors seek a formula for success. The unfortunate reality is that investment success cannot be captured in a mathematical equation or a computer program.

The first section of this book, chapters 1 through 4, examines some of the places where investors stumble. Chapter 1 explores the differences between investing and speculation and between successful and unsuccessful investors, examining in particular the role of market price in investor behavior. Chapter 2 looks at the way Wall Street, with its short-term orientation, conflicts of interest, and upward bias, maximizes its own best interests, which are not necessarily also those of investors. Chapter 3 examines the behavior of institutional investors, who have come to dominate today's financial markets.

Chapter 4 uses the case study of junk bonds to illustrate

many of the pitfalls highlighted in the first three chapters. The rapid growth of the market for newly issued junk bonds was only made possible by the complicity of investors who suspended disbelief. Junk-bond buyers greedily accepted promises of a free lunch and willingly adopted new and unproven methods of analysis. Neither Wall Street nor the institutional investment community objected vocally to the widespread proliferation of these flawed instruments.

Investors must recognize that the junk-bond mania was not a once-in-a-millennium madness but instead part of the historical ebb and flow of investor sentiment between greed and fear. The important point is not merely that junk bonds were flawed (although they certainly were) but that investors must learn from this very avoidable debacle to escape the next enticing market fad that will inevitably come along.

A second important reason to examine the behavior of other investors and speculators is that their actions often inadvertently result in the creation of opportunities for value investors. Institutional investors, for example, frequently act as lumbering behemoths, trampling some securities to large discounts from underlying value even as they ignore or constrain themselves from buying others. Those they decide to purchase they buy with gusto; many of these favorites become significantly overvalued, creating selling (and perhaps short-selling) opportunities. Herds of individual investors acting in tandem can similarly bid up the prices of some securities to crazy levels, even as others are ignored or unceremoniously dumped. Abetted by Wall Street brokers and investment bankers, many individual as well as institutional investors either ignore or deliberately disregard underlying business value, instead regarding stocks solely as pieces of paper to be traded back and forth.

The disregard for investment fundamentals sometimes affects the entire stock market. Consider, for example, the enormous surge in share prices between January and August of 1987 and the ensuing market crash in October of that year. In the words of William Ruane and Richard Cunniff, chairman and

president of the Sequoia Fund, Inc., "Disregarding for the moment whether the prevailing level of stock prices on January 1, 1987 was logical, we are certain that the *value* of American industry in the aggregate had not increased by 44% as of August 25. Similarly, it is highly unlikely that the *value* of American industry declined by 23% on a single day, October 19."¹

Ultimately investors must choose sides. One side—the wrong choice—is a seemingly effortless path that offers the *comfort of consensus*. This course involves succumbing to the forces that guide most market participants, emotional responses dictated by greed and fear and a short-term orientation emanating from the relative-performance derby. Investors following this road increasingly think of stocks like sowbellies, as commodities to be bought and sold. This ultimately requires investors to spend their time guessing what other market participants may do and then trying to do it first. The problem is that the exciting possibility of high near-term returns from playing the stocks-as-pieces-of-paper-that-you-trade game blinds investors to its foolishness.

The correct choice for investors is obvious but requires a level of commitment most are unwilling to make. This choice is known as fundamental analysis, whereby stocks are regarded as fractional ownership of the underlying businesses that they represent. One form of fundamental analysis—and the strategy that I recommend—is an investment approach known as value investing.

There is nothing esoteric about value investing. It is simply the process of determining the value underlying a security and then buying it at a considerable discount from that value. It is really that simple. The greatest challenge is maintaining the requisite patience and discipline to buy only when prices are attractive and to sell when they are not, avoiding the short-term performance frenzy that engulfs most market participants.

The focus of most investors differs from that of value investors. Most investors are primarily oriented toward return, how much they can make, and pay little attention to risk, how much they can lose. Institutional investors, in particular, are

usually evaluated—and therefore measure themselves—on the basis of relative performance compared to the market as a whole, to a relevant market sector, or to their peers.

Value investors, by contrast, have as a primary goal the preservation of their capital. It follows that value investors seek a margin of safety, allowing room for imprecision, bad luck, or analytical error in order to avoid sizable losses over time. A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as concerned about loss.

If investors could predict the future direction of the market, they would certainly not choose to be value investors all the time. Indeed, when securities prices are steadily increasing, a value approach is usually a handicap; out-of-favor securities tend to rise less than the public's favorites. When the market becomes fully valued on its way to being overvalued, value investors again fare poorly because they sell too soon.

The most beneficial time to be a value investor is when the market is falling. This is when downside risk matters and when investors who worried only about what could go right suffer the consequences of undue optimism. Value investors invest with a margin of safety that protects them from large losses in declining markets.

Those who can predict the future should participate fully, indeed on margin using borrowed money, when the market is about to rise and get out of the market before it declines. Unfortunately, many more investors claim the ability to foresee the market's direction than actually possess that ability. (I myself have not met a single one.) Those of us who know that we cannot accurately forecast security prices are well advised to consider value investing, a safe and successful strategy in all investment environments.

The second section of this book, chapters 5 through 8, explores the philosophy and substance of value investing. Chapter 5 examines why most investors are risk averse and dis-

cusses the investment implications of this attitude. Chapter 6 describes the philosophy of value investing and the meaning and importance of a margin of safety. Chapter 7 considers three important underpinnings to value investing: a bottom-up approach to investment selection, an absolute-performance orientation, and analytical emphasis on risk as well as return. Chapter 8 demonstrates the principal methods of securities valuation used by value investors.

The third section of this book, chapters 9 through 14, describes the value-investment process, the implementation of a value-investment philosophy. Chapter 9 explores the research and analytical process, where value investors get their ideas and how they evaluate them. Chapter 10 illustrates a number of different value-investment opportunities ranging from corporate liquidations to spinoffs and risk arbitrage. Chapters 11 and 12 examine two specialized value-investment niches: thrift conversions and financially distressed and bankrupt securities, respectively. Chapter 13 highlights the importance of good portfolio management and trading strategies. Finally, Chapter 14 provides some insight into the possible selection of an investment professional to manage your money.

The value discipline seems simple enough but is apparently a difficult one for most investors to grasp or adhere to. As Buffett has often observed, value investing is not a concept that can be learned and applied gradually over time. It is either absorbed and adopted at once, or it is never truly learned.

I was fortunate to learn value investing at the inception of my investment career from two of its most successful practitioners: Michael Price and the late Max L. Heine of Mutual Shares Corporation. While I had been fascinated by the stock market since childhood and frequently dabbled in the market as a teenager (with modest success), working with Max and Mike was like being let in on an incredibly valuable secret. How naive all of my previous investing suddenly seemed compared with the simple but incontrovertible logic of value investing. Indeed, once you adopt a value-investment strategy, any other investment behavior starts to seem like gambling.

Throughout this book I criticize certain aspects of the investment business as currently practiced. Many of these criticisms of the industry appear as generalizations and refer more to the pressures brought about by the structure of the investment business than the failings of the individuals within it.

I also give numerous examples of specific investments throughout this book. Many of them were made over the past nine years by my firm for the benefit of our clients and indeed proved quite profitable. The fact that we made money on them is not the point, however. My goal in including them is to demonstrate the variety of value-investment opportunities that have arisen and become known to me during the past decade; an equally long and rich list of examples failed to make it into the final manuscript.

I find value investing to be a stimulating, intellectually challenging, ever changing, and financially rewarding discipline. I hope you invest the time to understand why I find it so in the pages that follow.

Notes

1. **Sequoia Fund, Inc., third quarter report for 1987.**

I
**WHERE MOST
INVESTORS STUMBLE**

1

Speculators and Unsuccessful Investors

Investing Versus Speculation

Mark Twain said that there are two times in a man's life when he should not speculate: when he can't afford it and when he can. Because this is so, understanding the difference between investment and speculation is the first step in achieving investment success.

To investors stocks represent fractional ownership of underlying businesses and bonds are loans to those businesses. Investors make buy and sell decisions on the basis of the current prices of securities compared with the perceived values of those securities. They transact when they think they know something that others don't know, don't care about, or prefer to ignore. They buy securities that appear to offer attractive return for the risk incurred and sell when the return no longer justifies the risk.

Investors believe that over the long run security prices tend to reflect fundamental developments involving the underlying

businesses. Investors in a stock thus expect to profit in at least one of three possible ways: from free cash flow generated by the underlying business, which eventually will be reflected in a higher share price or distributed as dividends; from an increase in the multiple that investors are willing to pay for the underlying business as reflected in a higher share price; or by a narrowing of the gap between share price and underlying business value.

Speculators, by contrast, buy and sell securities based on whether they believe those securities will next rise or fall in price. Their judgment regarding future price movements is based, not on fundamentals, but on a prediction of the behavior of others. They regard securities as pieces of paper to be swapped back and forth and are generally ignorant of or indifferent to investment fundamentals. They buy securities because they "act" well and sell when they don't. Indeed, even if it were certain that the world would end tomorrow, it is likely that some speculators would continue to trade securities based on what they thought the market would do today.

Speculators are obsessed with predicting—guessing—the direction of stock prices. Every morning on cable television, every afternoon on the stock market report, every weekend in *Barron's*, every week in dozens of market newsletters, and whenever businesspeople get together, there is rampant conjecture on where the market is heading. Many speculators attempt to predict the market direction by using technical analysis—past stock price fluctuations—as a guide. Technical analysis is based on the presumption that past share price meanderings, rather than underlying business value, hold the key to future stock prices. In reality, no one knows what the market will do; trying to predict it is a waste of time, and investing based upon that prediction is a speculative undertaking.

Market participants do not wear badges that identify them as investors or speculators. It is sometimes difficult to tell the two apart without studying their behavior at length. Examining what they own is not a giveaway, for any security can be owned by investors, speculators, or both. Indeed, many "investment professionals" actually perform as speculators much of the time

because of the way they define their mission, pursuing short-term trading profits from predictions of market fluctuations rather than long-term investment profits based on business fundamentals. As we shall see, investors have a reasonable chance of achieving long-term investment success; speculators, by contrast, are likely to lose money over time.

Trading Sardines and Eating Sardines: The Essence of Speculation

There is the old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, "You don't understand. These are not eating sardines, they are trading sardines."¹

Like sardine traders, many financial-market participants are attracted to speculation, never bothering to taste the sardines they are trading. Speculation offers the prospect of instant gratification; why get rich slowly if you can get rich quickly? Moreover, speculation involves going along with the crowd, not against it. There is comfort in consensus; those in the majority gain confidence from their very number.

Today many financial-market participants, knowingly or unknowingly, have become speculators. They may not even realize that they are playing a "greater-fool game," buying overvalued securities and expecting—hoping—to find someone, a greater fool, to buy from them at a still higher price.

There is great allure to treating stocks as pieces of paper that you trade. Viewing stocks this way requires neither rigorous analysis nor knowledge of the underlying businesses. Moreover, trading in and of itself can be exciting and, as long as the market is rising, lucrative. But essentially it is speculating, not investing. You may find a buyer at a higher price—a greater fool—or you may not, in which case you yourself are the greater fool.

Value investors pay attention to financial reality in making their investment decisions. Speculators have no such tether. Since many of today's market participants are speculators and not investors, business fundamentals are not necessarily a limiting factor in securities pricing. The resulting propensity of the stock market to periodically become and remain overvalued is all the more reason for fundamental investors to be careful, avoiding any overpriced investments that will require selling to another, even greater fool.

Speculative activity can erupt on Wall Street at any time and is not usually recognized as such until considerable time has passed and much money has been lost. In the middle of 1983, to cite one example, the capital markets assigned a combined market value of over \$5 billion to twelve publicly traded, venture-capital-backed Winchester disk-drive manufacturers. Between 1977 and 1984 forty-three different manufacturers of Winchester disk drives received venture-capital financing. A Harvard Business School study entitled "Capital Market Myopia"² calculated that industry fundamentals (as of mid-1983) could not then nor in the foreseeable future have justified the total market capitalization of these companies. The study determined that a few firms might ultimately succeed and dominate the industry, while many of the others would struggle or fail. The high potential returns from the winners, if any emerged, would not offset the losses from the others. While investors at the time may not have realized it, the shares of these disk-drive companies were essentially "trading sardines." This speculative bubble burst soon thereafter, with the total market capitalization of these companies declining from \$5.4 billion in mid-1983 to \$1.5 billion at year-end 1984. Another example of such speculative activity took place in September 1989. The shares of the Spain Fund, Inc., a closed-end mutual fund investing in publicly traded Spanish securities, were bid up in price from approximately net asset value (NAV)—the combined market value of the underlying investments divided by the number of shares outstanding—to more than twice that level. Much of the buying emanated from Japan, where underlying value was evidently

less important to investors than other considerations. Although an identical portfolio to that owned by the Spain Fund could have been freely purchased on the Spanish stock market for half the price of Spain Fund shares, these Japanese speculators were not deterred. The Spain Fund priced at twice net asset value was another example of trading sardines; the only possible reason for buying the Spain Fund rather than the underlying securities was the belief that its shares would appreciate to an even more overpriced level. Within months of the speculative advance the share price plunged back to prerially levels, once again approximating the NAV, which itself had never significantly fluctuated.

For still another example of speculation on Wall Street, consider the U.S. government bond market in which traders buy and sell billions of dollars' worth of thirty-year U.S. Treasury bonds every day. Even long-term investors seldom hold thirty-year government bonds to maturity. According to Albert Wojnilower, the average holding period of U.S. Treasury bonds with maturities of ten years or more is only twenty days.³ Professional traders and so-called investors alike prize thirty-year Treasury bonds for their liquidity and use them to speculate on short-term interest rate movements, while never contemplating the prospect of actually holding them to maturity. Yet someone who buys long-term securities intending to quickly resell rather than hold is a speculator, and thirty-year Treasury bonds have also effectively become trading sardines. We can all wonder what would happen if the thirty-year Treasury bond fell from favor as a speculative vehicle, causing these short-term holders to rush to sell at once and turning thirty-year Treasury bonds back into eating sardines.

Investments and Speculations

Just as financial-market participants can be divided into two groups, investors and speculators, assets and securities can

often be characterized as either investments or speculations. The distinction is not clear to most people. Both investments and speculations can be bought and sold. Both typically fluctuate in price and can thus appear to generate investment returns. But there is one critical difference: investments throw off cash flow for the benefit of the owners; speculations do not.⁴ The return to the owners of speculations depends exclusively on the vagaries of the resale market.

The greedy tendency to want to own anything that has recently been rising in price lures many people into purchasing speculations. Stocks and bonds go up and down in price, as do Monets and Mickey Mantle rookie cards, but there should be no confusion as to which are the true investments. Collectibles, such as art, antiques, rare coins, and baseball cards, are not investments, but rank speculations. This may not be of consequence to the Chase Manhattan Bank, which in the late 1980s formed a fund for its clients to invest in art, or to David L. Paul, former chairman of the now insolvent CenTrust Savings and Loan Association, who spent \$13 million of the thrift's money to purchase just one painting. Even Wall Street, which knows better, chooses at times to blur the distinction. Salomon Brothers, for example, now publishes the rate of return on various asset classes, including in the same list U.S. Treasury bills, stocks, impressionist and old master paintings, and Chinese ceramics. In Salomon's June 1989 rankings the latter categories were ranked at the top of the list, far outdistancing the returns from true investments.

Investments, even very long-term investments like newly planted timber properties, will eventually throw off cash flow. A machine makes widgets that are marketed, a building is occupied by tenants who pay rent, and trees on a timber property are eventually harvested and sold. By contrast, collectibles throw off no cash flow; the only cash they can generate is from their eventual sale. The future buyer is likewise dependent on his or her own prospects for resale.

The value of collectibles, therefore, fluctuates solely with supply and demand. Collectibles have not historically been recog-

nized as stores of value, thus their prices depend on the vagaries of taste, which are certainly subject to change. The apparent value of collectibles is based on circular reasoning: people buy because others have recently bought. This has the effect of bidding up prices, which attracts publicity and creates the illusion of attractive returns. Such logic can fail at any time.

Investment success requires an appropriate mind-set. Investing is serious business, not entertainment. If you participate in the financial markets at all, it is crucial to do so as an investor, not as a speculator, and to be certain that you understand the difference. Needless to say, investors are able to distinguish Pepsico from Picasso and understand the difference between an investment and a collectible. When your hard-earned savings and future financial security are at stake, the cost of not distinguishing is unacceptably high.

The Differences between Successful and Unsuccessful Investors

Successful investors tend to be unemotional, allowing the greed and fear of others to play into their hands. By having confidence in their own analysis and judgment, they respond to market forces not with blind emotion but with calculated reason. Successful investors, for example, demonstrate caution in frothy markets and steadfast conviction in panicky ones. Indeed, the very way an investor views the market and its price fluctuations is a key factor in his or her ultimate investment success or failure.

Taking Advantage of Mr. Market

I wrote earlier that financial-market participants must choose between investment and speculation. Those who (wisely) choose investment are faced with another choice, this time between two opposing views of the financial markets. One view, widely held among academics and increasingly among

institutional investors, is that the financial markets are efficient and that trying to outperform the averages is futile. Matching the market return is the best you can hope for. Those who attempt to outperform the market will incur high transaction costs and taxes, causing them to underperform instead.

The other view is that some securities are inefficiently priced, creating opportunities for investors to profit with low risk. This view was perhaps best expressed by Benjamin Graham, who posited the existence of a Mr. Market.⁵ An ever helpful fellow, Mr. Market stands ready every business day to buy or sell a vast array of securities in virtually limitless quantities at prices that he sets. He provides this valuable service free of charge. Sometimes Mr. Market sets prices at levels where you would neither want to buy nor sell. Frequently, however, he becomes irrational. Sometimes he is optimistic and will pay far more than securities are worth. Other times he is pessimistic, offering to sell securities for considerably less than underlying value. Value investors—who buy at a discount from underlying value—are in a position to take advantage of Mr. Market's irrationality.

Some investors—really speculators—mistakenly look to Mr. Market for investment guidance. They observe him setting a lower price for a security and, unmindful of his irrationality, rush to sell their holdings, ignoring their own assessment of underlying value. Other times they see him raising prices and, trusting his lead, buy in at the higher figure *as if he knew more than they*. The reality is that Mr. Market knows nothing, being the product of the collective action of thousands of buyers and sellers who themselves are not always motivated by investment fundamentals. Emotional investors and speculators inevitably lose money; investors who take advantage of Mr. Market's periodic irrationality, by contrast, have a good chance of enjoying long-term success.

Mr. Market's daily fluctuations may seem to provide feedback for investors' recent decisions. For a recent purchase decision rising prices provide positive reinforcement; falling prices, negative reinforcement. If you buy a stock that subsequently rises in price, it is easy to allow the positive feedback provided

by Mr. Market to influence your judgment. You may start to believe that the security is worth more than you previously thought and refrain from selling, effectively placing the judgment of Mr. Market above your own. You may even decide to buy more shares of this stock, anticipating Mr. Market's future movements. As long as the price appears to be rising, you may choose to hold, perhaps even ignoring deteriorating business fundamentals or a diminution in underlying value.

Similarly, when the price of a stock declines after its initial purchase, most investors, somewhat naturally, become concerned. They start to worry that Mr. Market may know more than they do or that their original assessment was in error. It is easy to panic and sell at just the wrong time. Yet if the security were truly a bargain when it was purchased, the rational course of action would be to take advantage of this even better bargain and buy more.

Louis Lowenstein has warned us not to confuse the real success of an investment with its mirror of success in the stock market.⁶ The fact that a stock price rises does not ensure that the underlying business is doing well or that the price increase is justified by a corresponding increase in underlying value. Likewise, a price fall in and of itself does not necessarily reflect adverse business developments or value deterioration.

It is vitally important for investors to distinguish stock price fluctuations from underlying business reality. If the general tendency is for buying to beget more buying and selling to precipitate more selling, investors must fight the tendency to capitulate to market forces. You cannot ignore the market—ignoring a source of investment opportunities would obviously be a mistake—but you must think for yourself and not allow the market to direct you. Value in relation to price, not price alone, must determine your investment decisions. If you look to Mr. Market as a creator of investment opportunities (where price departs from underlying value), you have the makings of a value investor. If you insist on looking to Mr. Market for investment guidance, however, you are probably best advised to hire someone else to manage your money.

Security prices move up and down for two basic reasons: to

reflect business reality (or investor perceptions of that reality) or to reflect short-term variations in supply and demand. Reality can change in a number of ways, some company-specific, others macroeconomic in nature. If Coca-Cola's business expands or prospects improve and the stock price increases proportionally, the rise may simply reflect an increase in business value. If Aetna's share price plunges when a hurricane causes billions of dollars in catastrophic losses, a decline in total market value approximately equal to the estimated losses may be appropriate. When the shares of Fund American Companies, Inc., surge as a result of the unexpected announcement of the sale of its major subsidiary, Fireman's Fund Insurance Company, at a very high price, the price increase reflects the sudden and nearly complete realization of underlying value. On a macroeconomic level a broad-based decline in interest rates, a drop in corporate tax rates, or a rise in the expected rate of economic growth could each precipitate a general increase in security prices.

Security prices sometimes fluctuate, not based on any apparent changes in reality, but on changes in investor perception. The shares of many biotechnology companies doubled and tripled in the first months of 1991, for example despite a lack of change in company or industry fundamentals that could possibly have explained that magnitude of increase. The only explanation for the price rise was that investors were suddenly willing to pay much more than before to buy the same thing.

In the short run supply and demand alone determine market prices. If there are many large sellers and few buyers, prices fall, sometimes beyond reason. Supply-and-demand imbalances can result from year-end tax selling, an institutional stampede out of a stock that just reported disappointing earnings, or an unpleasant rumor. Most day-to-day market price fluctuations result from supply-and-demand variations rather than from fundamental developments.

Investors will frequently not know why security prices fluctuate. They may change because of, in the absence of, or in complete indifference to changes in underlying value. In the short run investor perception may be as important as reality itself in

determining security prices. It is never clear which future events are anticipated by investors and thus already reflected in today's security prices. Because security prices can change for any number of reasons and because it is impossible to know what expectations are reflected in any given price level, investors must look beyond security prices to underlying business value, always comparing the two as part of the investment process.

Unsuccessful Investors and Their Costly Emotions

Unsuccessful investors are dominated by emotion. Rather than responding coolly and rationally to market fluctuations, they respond emotionally with greed and fear. We all know people who act responsibly and deliberately most of the time but go berserk when investing money. It may take them many months, even years, of hard work and disciplined saving to accumulate the money but only a few minutes to invest it. The same people would read several consumer publications and visit numerous stores before purchasing a stereo or camera yet spend little or no time investigating the stock they just heard about from a friend. Rationality that is applied to the purchase of electronic or photographic equipment is absent when it comes to investing.

Many unsuccessful investors regard the stock market as a way to make money without working rather than as a way to invest capital in order to earn a decent return. Anyone would enjoy a quick and easy profit, and the prospect of an effortless gain incites greed in investors. Greed leads many investors to seek shortcuts to investment success. Rather than allowing returns to compound over time, they attempt to turn quick profits by acting on hot tips. They do not stop to consider how the tipster could possibly be in possession of valuable information that is not illegally obtained or why, if it is so valuable, it is being made available to them. Greed also manifests itself as undue optimism or, more subtly, as complacency in the face of

bad news. Finally greed can cause investors to shift their focus away from the achievement of long-term investment goals in favor of short-term speculation.

High levels of greed sometimes cause new-era thinking to be introduced by market participants to justify buying or holding overvalued securities. Reasons are given as to why this time is different from anything that came before. As the truth is stretched, investor behavior is carried to an extreme. Conservative assumptions are revisited and revised in order to justify ever higher prices, and a mania can ensue. In the short run resisting the mania is not only psychologically but also financially difficult as the participants make a lot of money, at least on paper. Then, predictably, the mania reaches a peak, is recognized for what it is, reverses course, and turns into a selling panic. Greed gives way to fear, and investor losses can be enormous.

As I discuss later in detail, junk bonds were definitely such a mania. Prior to the 1980s the entire junk-bond market consisted of only a few billion dollars of "fallen angels." Although newly issued junk bonds were a 1980s invention and were thus untested over a full economic cycle, they became widely accepted as a financial innovation of great importance, with total issuance exceeding \$200 billion. Buyers greedily departed from historical standards of business valuation and creditworthiness. Even after the bubble burst, many proponents stubbornly clung to the validity of the concept.

Greed and the Yield Pigs of the 1980s

There are countless examples of investor greed in recent financial history. Few, however, were as relentless as the decade-long "reach for yield" of the 1980s. Double-digit interest rates on U.S. government securities early in the decade whetted investors' appetites for high nominal returns. When interest rates declined to single digits, many investors remained infatuated with the attainment of higher yields and sacrificed credit quality to achieve them either in the bond market or in equities. Known

among Wall Streeters as "yield pigs" (or a number of more derivative names), such individual and institutional investors were susceptible to any investment product that promised a high rate of return. Wall Street responded with gusto, as Wall Street tends to do when there are fees to earn, creating a variety of instruments that promised high current yields.

U.S. government securities are generally regarded as "risk-free" investments, at least insofar as credit quality is concerned. To achieve current cash yields appreciably above those available from U.S. government securities, investors must either risk the loss of principal or incur its certain depletion. Low-grade securities, such as junk bonds, offer higher yields than government bonds but at the risk of principal loss. Junk-bond mutual funds were marketed to investors in the 1980s primarily through the promise of high current yield. As with a magician performing sleight of hand, investors' eyes were focused almost exclusively on the attractive current yield, while the high principal risk from defaults was hidden from view.

Junk bonds were not the only slop served up to the yield pigs of the 1980s. Wall Street found many ways to offer investors an enhanced current yield by incorporating a return of the investors' principal into the reported yield. "Ginnie Maes," which are, in fact, high-grade securities, are one such example. These are pools of mortgages insured by the Government National Mortgage Association (GNMA, whence Ginnie Mae), a U.S. government agency. GNMA pools collect mortgage interest and principal payments from homeowners and distribute them to bondholders. Every month owners of GNMA's receive distributions that include both interest income and small principal repayments. The principal portion includes contractual payments as well as voluntary prepayments. Many holders tend to think of the yield on GNMA's in terms of the total monthly distribution received. The true economic yield is, in fact, only the interest payments received divided by the outstanding principal balance. The principal component of the monthly distributions is not a yield *on* capital, but a return *of* capital. Thus investors who spend the entire cash flow are eating into their seed corn.

The same principle is operative in option-income mutual

funds, which typically acquire a portfolio of U.S. government securities and then write (sell) call options against them. (A call option is the right to buy a security at a specified price during a stated period of time.) The cash distributions paid by these funds to shareholders are comprised of both interest income earned on the bond portfolio and premiums generated from the sale of options. This total cash distribution is touted as the current yield to investors. When covered call options written against the portfolio are exercised, however, the writer forgoes appreciation on the securities that are called away. The upside potential on the underlying investments is truncated by the sale of the call options, while the downside risk remains intact. This strategy places investors in the position of uninsured homeowners, who benefit currently from the small premium not paid to the insurance company while remaining exposed to large future losses. As long as security prices continue to fluctuate both up and down, writers of covered calls are certain to experience capital losses over time, with no possible offsetting capital gains. In effect, these funds are eating into principal while misleadingly reporting the principal erosion as yield.

Some investors, fixated on current return, reach for yield not with a new Wall Street product, but a very old one: common stocks. Finding bond yields unacceptably low, they pour money into stocks at the worst imaginable times. These investors fail to consider that bond market yields are public information, well known to stock investors who incorporate the current level of interest rates into share prices. When bond yields are low, share prices are likely to be high. Yield-seeking investors who rush into stocks when yields are low not only fail to achieve a free lunch, they also tend to buy in at or near a market top.

The Search for an Investment Formula

Many investors greedily persist in the investment world's version of a search for the holy grail: the attempt to find a successful investment formula. It is human nature to seek simple

solutions to problems, however complex. Given the complexities of the investment process, it is perhaps natural for people to feel that only a formula could lead to investment success.

Just as many generals persist in fighting the last war, most investment formulas project the recent past into the future. Some investment formulas involve technical analysis, in which past stock-price movements are considered predictive of future prices. Other formulas incorporate investment fundamentals such as price-to-earnings (P/E) ratios, price-to-book-value ratios, sales or profits growth rates, dividend yields, and the prevailing level of interest rates. Despite the enormous effort that has been put into devising such formulas, none has been proven to work.

One simplistic, backward-looking formula employed by some investors is to buy stocks with low P/E ratios. The idea is that by paying a low multiple of earnings, an investor is buying an out-of-favor bargain. In reality investors who follow such a formula are essentially driving by looking only in the rear-view mirror. Stocks with a low P/E ratio are often depressed because the market price has already discounted the prospect of a sharp fall in earnings. Investors who buy such stocks may soon find that the P/E ratio has risen because earnings have declined.

Another type of formula used by many investors involves projecting their most recent personal experiences into the future. As a result, many investors have entered the 1990s having "learned" a number of wrong and potentially dangerous lessons from the ebullient 1980s market performance; some have come to regard the 1987 stock market crash as nothing more than an aberration and nothing less than a great buying opportunity. The quick recovery after the October 1989 stock market shakeout and 1990 junk-bond market collapse provide reinforcement of this shortsighted lesson. Many investors, like Pavlov's dog, will foolishly look to the next market selloff, regardless of its proximate cause, as another buying "opportunity."

The financial markets are far too complex to be incorporated into a formula. Moreover, if any successful investment formula could be devised, it would be exploited by those who possessed it until competition eliminated the excess profits. The quest for

a formula that worked would then begin anew. Investors would be much better off to redirect the time and effort committed to devising formulas into fundamental analysis of specific investment opportunities.

Conclusion

The financial markets offer many temptations to vulnerable investors. It is easy to do the wrong thing, to speculate rather than invest. Emotion lies dangerously close to the surface for most investors and can be particularly intense when market prices move dramatically in either direction. It is crucial that investors understand the difference between speculating and investing and learn to take advantage of the opportunities presented by Mr. Market.

Notes

1. Sequoia Fund, Inc., annual report for 1986.
2. William A. Sahlman and Howard H. Stevenson (Harvard Graduate School of Business Administration Case Study), "Capital Market Myopia" (Cambridge: Harvard Business School, 1985).
3. Albert Wojnilower, quoted in Louis Lowenstein, *What's Wrong with Wall Street* (Reading, Mass.: Addison-Wesley, 1988), p. 75.
4. The only possible exceptions to this cash flow test are precious metals, such as gold, which is a widely recognized store of value; throughout history, for instance, the value of an ounce of gold has been roughly equivalent to the cost of a fine men's suit. Other precious metals and gems have a less-established value than gold but might be considered by some to be a similar type of holding.
5. Benjamin Graham, *The Intelligent Investor*, 4th ed. (New York: Harper & Row, 1973), p. 108.
6. Lowenstein, *What's Wrong with Wall Street*, p. 37.

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The Nature of Wall Street Works Against Investors

Investors in marketable securities have little choice but to deal with Wall Street. The sad truth is, however, that many investors are not well served in their dealings with Wall Street; they would benefit from developing a greater understanding of the way Wall Street works. The problem is that what is good for Wall Street is not necessarily good for investors, and vice versa.

Wall Street has three principal activities: trading, investment banking, and merchant banking. As traders Wall Street firms act as agents, earning a commission (or trading spread) for bringing buyers and sellers together. As investment bankers they arrange for the purchase and sale of entire companies by others, underwrite new securities, provide financial advice, and opine on the fairness of specific transactions. As merchant bankers they commit their own capital while acting as principal in investment banking transactions. Merchant banking activity became increasingly important to Wall Street in the late 1980s but almost completely ceased in 1990 and early 1991.

Wall Street firms perform important functions for our economy: they raise capital for expanding businesses and (some-

times) provide liquidity to markets. As Wall Street pursues its various activities, however, it frequently is plagued by conflicts of interest and a short-term orientation. Investors need not condemn Wall Street for this as long as they remain aware of it and act with cautious skepticism in any interactions they may have.

Up-Front Fees and Commissions: Wall Street's Primary Conflict of Interest

Wall Streeters get paid primarily for what they do, not how effectively they do it. Wall Street's traditional compensation is in the form of up-front fees and commissions. Brokerage commissions are collected on each trade, regardless of the outcome for the investor. Investment banking and underwriting fees are also collected up front, long before the ultimate success or failure of the transaction is known.

All investors are aware of the conflict of interest facing stockbrokers. While their customers might be best off owning (minimal commission) U.S. Treasury bills or (commission-free) no-load mutual funds, brokers are financially motivated to sell high-commission securities. Brokers also have an incentive to do excessive short-term trading (known as churning) on behalf of discretionary customer accounts (in which the broker has discretion to transact) and to encourage such activity in nondiscretionary accounts. Many investors are also accustomed to conflicts of interest in Wall Street's trading activities, where the firm and customer are on opposite sides of what is often a zero-sum game.

A significant conflict of interest also arises in securities underwriting. This function involves raising money for corporate clients by selling newly issued securities to customers. Needless to say, large fees may motivate a firm to underwrite either overpriced or highly risky securities and to favor the limited number of underwriting clients over the many small buyers of those securities.

In merchant banking the conflict is more blatant still. Wall

Street firms have become direct competitors of both their underwriting and brokerage clients, buying and selling entire companies or large corporate subsidiaries for their own accounts. Instead of acting as middlemen between issuers and buyers of securities, firms have become issuers and investors themselves. Nowadays when the phone rings and your broker is on the line, you don't even know in what capacity or on whose behalf he or she is acting.

Obviously there is nothing wrong with providing a service and collecting a fee. Doctors, lawyers, accountants, and other professionals are paid this way; their compensation does not depend on the ultimate outcome of their services. The point I am making is that investors should be aware of the motivations of the people they transact business with; up-front fees clearly create a bias toward frequent, and not necessarily profitable, transactions.

Wall Street Favors Underwritings over Secondary-Market Transactions

By acting as investment bankers as well as brokers, most Wall Street firms create their own products to sell. A stock or bond underwriting generates high fees for an investment bank. These are shared with stockbrokers who sell the underwritten securities to clients. The total Wall Street take from a stock underwriting, for example, ranges from 2 to 8 percent of the proceeds raised; the brokers themselves typically receive fifteen to thirty cents of gross commission on a \$10 stock.

By contrast, the commissions earned by brokers on secondary-market transactions, which involve the resale of securities from one investor to another, are much smaller. Large institutions generally pay as little as five cents per share and sometimes as low as two cents. Small individual investors are typically charged considerably more. Even so, brokers earn on average several times more money from selling shares in a new

underwriting than they can earn from a secondary-market transaction of similar size. The higher commission on new underwritings provides a strong incentive to stockbrokers to sell them to clients.

The strong financial incentive of brokers touting new security underwritings is not the only cause for investor concern. The motivation of the issuer of securities is also suspect and must be thoroughly investigated by the buyer. Gone are the days (if they ever existed) when a new issue was a collaborative effort in which a business that was long on prospects but short on capital could meet investors with capital in hand but with few good outlets for it. Today the initial public offering market is where hopes and dreams are capitalized at high multiples. Indeed, the underwriting of a new security may well be an overpriced or ill-conceived transaction, frequently involving the shuffling of assets through "financial engineering" rather than the raising of capital to finance a business's internal growth.

Investors even remotely tempted to buy new issues must ask themselves how they could possibly fare well when a savvy issuer and greedy underwriter are on the opposite side of every underwriting. Indeed, how attractive could any security underwriting ever be when the issuer and underwriter have superior information as well as control over the timing, pricing, and stock or bond allocation? The deck is almost always stacked against the buyers.

Sometimes the lust for underwriting fees drives Wall Street to actually create underwriting clients for the sole purpose of having securities to sell. Most closed-end mutual funds, for example, are formed almost exclusively to generate commissions for stockbrokers and fees for investment managers. There was a story a few years ago that an announcement to the sales force of a prestigious Wall Street underwriting firm regarding the formation of a closed-end bond fund was met with a standing ovation. The clients could have purchased the same securities much less expensively on a direct basis, but in the form of a closed-end fund the brokers stood to make many times more in commissions.

Closed-end mutual funds are typically offered initially to investors at \$10 per share; an 8 percent commission is paid to the underwriter, leaving \$9.20 to invest. Within months of issuance, closed-end funds typically decline in price below the initial per share net asset value (the market value of the underlying holdings) of \$9.20. This means that purchasers of closed-end funds on the initial public offering frequently incur a quick loss of 10 to 15 percent of their investment. From the initial purchasers' perspective the same purpose could be achieved less expensively through existing no-load open-end mutual funds. These funds are able to make the same investments as closed-end funds but no underwriting fee or sales charge is paid; unlike closed-end funds, they can always be bought and sold at net asset value (NAV).¹

The 1989–90 boom in the creation of new closed-end country funds exemplifies the tension between Wall Street and its customers. As noted in chapter 1, speculative interest in closed-end country funds resulted in the shares of many funds being bid far above underlying NAVs. Buying into new offerings appeared to be a quick, easy, and almost certain way to make money. In June 1989, for example, the Spain Fund, Inc., sold at 92 percent of NAV, an 8 percent discount. Only three months later the shares traded at more than 260 percent of NAV and remained at more than twice NAV until February 1990. By late summer of that year the share price once again approximated NAV, which was somewhat lower than it had been a year earlier. This price trend is not unique; the share prices of several other country funds underwent similar gyrations.

Investor enthusiasm for country funds was bolstered by the sudden collapse of communism and the democratization of Eastern Europe; peace appeared to be "breaking out" around the world. Funds were formed to invest in such exotic locales as Austria, Brazil, Ireland, Thailand, and Turkey. Ironically, only months after the boom in issuance of closed-end country funds peaked, Iraq invaded Kuwait. The price of oil rose sharply, recession fears mounted, and stock markets worldwide plunged. The prospect of finding new buyers who would pay

even greater premiums to NAV suddenly dimmed. As a result, newly bearish investors dumped the shares of country funds, which had recently traded at large premiums to NAV, until virtually all of them declined to levels appreciably below NAV.

The periodic boom in closed-end mutual-fund issuance is a useful barometer of market sentiment; new issues abound when investors are optimistic and markets are rising. Wall Street firms after all do not force investors to buy these funds. They simply stand ready to issue a virtually limitless supply since the only real constraint is the gullibility of the buyers. The boom is followed by a bust, during which those funds that fall to a sufficiently large discount to NAV are targeted by investor groups and either liquidated or forced to become open-ended, thereby permitting the shares to be redeemable at NAV, completing the life cycles of these entities. The underwriters and sometimes the bargain hunters profit; the greater fools who buy on the initial public offerings or later at large premiums to NAV inevitably lose money.

Wall Street's Short-Term Focus

Wall Street's up-front-fee orientation makes for a short-term focus as well. Brokers, traders, and investment bankers all find it hard to look beyond the next transaction when the current one is so lucrative regardless of merit. This was even more applicable than usual in the late 1980s and early 1990s, a time when fees were enormous and when most Wall Streeters felt less than secure about the permanence of their jobs, and even their careers, in the securities industry. The utter hypocrisy of Wall Street is exemplified by the "equitization" wave of early 1991, whereby overleveraged companies issued equity and used the proceeds to repay debt. Wall Street collected investment banking and underwriting fees when those companies were acquired in highly leveraged junk-bond-financed takeovers and collected large fees again when the debt was replaced with newly underwritten equity.

Some people work on Wall Street solely to earn high incomes, expecting to depart after a few years. Others, doubting their own ultimate success, perhaps justifiably, are unwilling to forego short-term compensation for long-term income that may never arrive. The compensation figures are so large that even a few good years on Wall Street can ensure a person's financial security for life.

Notwithstanding, a minority of people on Wall Street have maintained a long-term perspective. A few Wall Street partnerships have done a particularly good job of motivating their employees to think past the current transaction. However, a great many of those who work on Wall Street view the goodwill or financial success of clients as a secondary consideration; short-term maximization of their own income is the primary goal.

Many Wall Streeters, especially stockbrokers, have come to believe that their clients will normally leave them after a couple of years, in effect rationalizing their own short-term orientations by blaming their clients. There are no sure things on Wall Street, and even the best-intentioned and most insightful advice may not work out. It is true that clients who incur losses may switch brokers. This does not excuse those who assume that client turnover is the norm and thus seek to maximize commissions and fees over the short term, making client turnover a self-fulfilling prophecy.

Wall Street's Bullish Bias

Investors must never forget that Wall Street has a strong bullish bias, which coincides with its self-interest. Wall Street firms can complete more security underwritings in good markets than in bad. Brokers, likewise, do more business and have happier customers in a rising market. Even securities held in inventory to facilitate trading tend to increase in price during bull markets. When a Wall Street analyst or broker expresses optimism, investors must take it with a grain of salt.

The bullish bias of Wall Street manifests itself in many ways. Wall Street research is strongly oriented toward buy rather than sell recommendations, for example. Perhaps this is the case because anyone with money is a candidate to buy a stock or bond, while only those who own are candidates to sell. In other words, there is more brokerage business to be done by issuing an optimistic research report than by writing a pessimistic one.

In addition, Wall Street analysts are unlikely to issue sell recommendations due to an understandable reluctance to say negative things, however truthful they may be, about the companies they follow. This is especially true when these companies are corporate-finance clients of the firm. In 1990 Marvin Roffman, an analyst at Janney Montgomery Scott, Inc., apparently lost his job for writing a negative research report about the Atlantic City hotel/casinos owned by Donald Trump, a prospective client of Janney.

It is easy for Wall Streeters to be bullish. A few optimistic assumptions will enable a reasonable investment case to be made for practically any stock or bond. The problem is that with so much attention being paid to the upside, it is easy to lose sight of the risk.

Others share Wall Street's bullish bias. Investors naturally prefer rising security prices to falling ones, profits to losses. It is more pleasant to contemplate upside potential than downside risk. Companies too prefer to see their own shares rise in price; an increasing share price is viewed as a vote of confidence in management, as a source of increase in the value of management's personal shares and stock options, and as a source of financial flexibility, facilitating a company's ability to raise additional equity capital.

Even government regulators of the securities markets have a stake in the markets' bullish bias. Rising markets are accompanied by investor confidence, which the regulators desire to maintain. Any downturn, according to the regulatory mentality, should be orderly and free of panic. (Disorderly rising markets are of no evident concern.)

Accordingly, market regulators have devised certain stock market rules that have the effect of exacerbating the upward bias of Wall Streeters. First, many institutions, including all mutual funds, are prohibited from selling stocks or bonds short. (A short sale involves selling borrowed stocks or bonds; it is the opposite of the traditional investment strategy of buying a security, otherwise known as going long.) Second, while there are no restrictions on buying a stock, the short sale of exchange-listed stocks requires physically borrowing the desired number of shares and then executing a sell order on an "uptick" (an upward price fluctuation) from the preceding trade.² This can greatly limit investors' ability to execute short-sale transactions. The combination of restrictive short-sale rules and the limited number of investors who are both willing and able to accept the unlimited downside risk of short-selling increases the likelihood that security prices may become overvalued. Short-sellers, who might otherwise step in to correct an overvaluation, are few in number and significantly constrained.³

After the October 1987 stock market crash several "circuit breakers" were introduced to limit downward price swings on a given day. These included restrictions on the price movement of stocks and index futures and on program trading.⁴ The effect of circuit breakers ranges from a temporary halt in futures trading to a complete market shutdown.

Two New York Stock Exchange circuit breakers apply only to market declines. If the Dow Jones Industrial Average falls 250 points below the previous day's close, trading is stopped for one hour. If stocks fall another 150 points after trading resumes, there will be an additional two-hour halt. It is noteworthy that there is no similar provision regarding upward price movements, regardless of magnitude. This is another example of how the rules favor bulls over bears and militate toward higher stock prices. Although high stock prices cannot be legislated (something that many on Wall Street may secretly wish), regulation can cause overvaluation to persist by making it easier to occur and more difficult to correct. The upward bias of market regula-

tors, illustrated by the uneven application of circuit breakers, may itself encourage investors to purchase and hold overvalued securities.

Many of the same factors that contribute to a bullish bias can cause the financial markets, especially the stock market, to become and remain overvalued. Correcting a market overvaluation is more difficult than remedying an undervalued condition. With an undervalued stock, for example, a value investor can purchase more and more shares until control is achieved or, better still, until the entire company is owned at a bargain price. If the value assessment was accurate, this is an attractive outcome for the investor. By contrast, overvalued markets are not easily corrected; short-selling, as mentioned earlier, is not an effective antidote. In addition, overvaluation is not always apparent to investors, analysts, or managements. Since security prices reflect investors' perception of reality and not necessarily reality itself, overvaluation may persist for a long time.

Financial-Market Innovations Are Good for Wall Street But Bad for Clients

Investment bankers in Wall Street firms are constantly creating new types of securities to offer to customers. Occasionally such offerings both solve the financial problems of issuers and meet the needs of investors. In most cases, however, they address only the needs of Wall Street, that is, the generation of fees and commissions.

Financial intermediaries—Wall Street investment bankers and institutional investors—stand to benefit the most from financial-market innovations. Wall Street earns fees and commissions with no risk; institutional investors may be able to attract more money to manage by creating new vehicles to invest in the innovative securities. If the first investors in a financial-market innovation experience good results, more

money will be raised and more securities will be issued, generating additional management fees, underwriting fees, and commissions. The buy side and sell side in effect become co-conspirators, each having a vested interest in the continued success of the innovation. Any long-term benefit to the issuers or actual owners of the new securities is considerably less certain.

In the 1980s the financial markets were flooded with new varieties of debt and derivative securities. Just to name a few, an investor could buy bonds that were fixed or floating rate, Dutch auction, zero-coupon, pay-in-kind or pay-in-stock, convertible into the issuers' stock, into someone else's stock, or into commodities, puttable, callable, resettable, extendible to a longer maturity, exchangeable into another security, or denominated in a foreign currency or market basket of currencies. Some of these securities, such as auction-rate preferred-stock and zero-coupon junk bonds, have been discredited by events. Many others, like exhibits at a science fair, may have achieved their original goals, but almost no one really cared.

Investors must recognize that the early success of an innovation is not a reliable indicator of its ultimate merit. Both buyers and sellers must believe that they will benefit in the short run, or the innovation will not get off the drawing board; the longer-term consequences of such innovations, however, may not have been considered carefully. At the time of issuance a new type of security will appear to add value in the same way that a new consumer product does. There is something—lower risk, higher return, greater liquidity, an imbedded put or call option to the holder or issuer, or some other wrinkle—that makes it appear superior (new and improved, if you will) to anything that came before. Although the benefits are apparent from the start, it takes longer for problems to surface. Neither cash-hungry issuers nor greedy investors necessarily analyze the performance of each financial-market innovation under every conceivable economic scenario. What appears to be new and improved today may prove to be flawed or even fallacious

tomorrow.

Wall Street is never satisfied with its success. If one deal is successfully completed, Wall Street sees this as a sure sign that still another deal can be done. In virtually all financial innovations and investment fads, Wall Street creates additional supply until it equals and then exceeds market demand. The profit motivation of Wall Street firms and the intense competition among them render any other outcome unlikely.

The eventual market saturation of Wall Street fads coincides with a cooling of investor enthusiasm. When a particular sector is in vogue, success is a self-fulfilling prophecy. As buyers bid up prices, they help to justify their original enthusiasm. When prices peak and start to decline, however, the downward movement can also become self-fulfilling. Not only do buyers stop buying, they actually become sellers, aggravating the oversupply problem that marks the peak of every fad.

IOs and POs: Innovations in the Mortgage Securities Market

One financial-market innovation of the mid-1980s involved hybrid mortgage securities known as IOs (interest only) and POs (principal only). IOs and POs were created by separating a pool of mortgages into its two cash-flow components: interest payments and principal repayments.

A conventional mortgage-backed security fluctuates in value inversely to interest rates for two reasons. First, the value of a mortgage declines as interest rates rise because, as with any interest-bearing security, it is worth less when its periodic cash flows are discounted at the new, higher rate. Second, the expected life of a mortgage lengthens with higher interest rates as optional prepayments lessen, so that the relatively less attractive interest payments last for a longer time.

The responses of separate IOs and POs to interest rate changes are very different from those of an intact mortgage-

backed security. IOs, interest payments stripped from a pool of mortgages, fluctuate in value for a given change in interest rates in the opposite direction from conventional mortgages. The reason is, if interest rates rise, interest payments on an IO will be received for a longer period. Experience shows that the present value of a larger number of payments is more than that of a smaller number of payments, even at a somewhat higher discount rate. Because of this counterfluctuation, such mortgage investors as thrifts and insurance companies are attracted to IOs as a potential hedge against changes in interest rates. The price of POs, conversely, moves in the same direction as conventional mortgages in response to interest rate changes but with greater volatility. Thus they are potentially useful instruments for anyone wishing to speculate on interest rates.

Wall Street was able to earn substantial fees and trading profits by creating these hybrid securities. The question, as with any financial-market innovation, is whether anyone else was better off, especially after allowing for the commissions, fees, and dealer markups. The buyers, frequently thrifts and insurance companies, were betting on their own ability to understand a brand new security. They needed to understand it better than other market participants, and at least as well as Wall Street, to avoid being exploited. They depended on the emergence of a sustained, liquid market for the securities they bought. And they were implicitly assuming that the two parts were worth at least as much as, and perhaps more than, the whole—clearly an optimistic assumption.

What if IOs or POs failed to trade in a liquid and orderly market with narrow bid/asked spreads? What if accurate and timely information on these securities ceased to be available on a continuing basis? What if interest rate fluctuations rendered each of these securities more volatile than expected? Then holders were in trouble, for it is far easier to separate a mortgage into two parts than it is to glue it back together again. There was no assurance, or even reason to think it likely, that the holder of one piece would be interested in any proposition made by the holder of the other piece to recombine. It was, in other words, possible

that the value of the two parts would be less than the value of the whole; at least one and perhaps both pieces could trade at a discount from theoretical underlying value.

Investment Fads

When a particular security catches Wall Street's fancy, billions of dollars' worth may be issued. Securities are not the only things that can come into favor on Wall Street, however; entire industries do as well. During the 1980s such diverse industries as energy, technology, biotechnology, gambling, warehouse shopping, and even defense basked in the limelight for a time. A boom in the issuance of securities for a particular industry can be lucrative for Wall Street since early success in each area attracts throngs of investors. Initial public offerings ensue, and closed-end mutual funds are often formed; investors' assets are shifted into the newly popular area, generating profits for Wall Street that remain long after investor enthusiasm wanes.

Companies that were viewed as having "business franchises" are one such example of a passing fashion of the late 1980s. A "nifty fifty" quickly emerged, several dozen institutional favorites that traded at considerably higher multiples than the rest of the stock market. Investors soon found excuses to characterize almost anything as a franchise. Businesses that barely existed in the early 1980s, such as Silk Greenhouse, Inc. (fake-flower stores) and TCBY (This Country's Best Yogurt) Enterprises, Inc., were claimed by investors in the late 1980s to have considerable franchise value. Each has since fallen from investor favor, and franchise value is no longer mentioned, except disparagingly, when these firms are discussed.

Ironically, many businesses that formerly had real consumer franchises lost them in the 1980s. The skies were not very friendly to Eastern, Pan Am, Continental, or TWA. Crazy Eddie went bankrupt. E. F. Hutton was no longer talking; its customers, no longer listening. B. Altman went out of business, and

the Bank of New England was taken over by regulators. Of course, some companies do have valuable business franchises, but these are neither so permanent nor so resilient as many investors believe. Even reasonably healthy companies like Eastman Kodak and American Express, for example, have seen competitors make significant inroads into their franchises in recent years.

Home shopping on television became an instant investment fad in 1986 with the initial public offering of Home Shopping Network, Inc., a company thought by investors to have tremendous growth potential. By early 1987, despite large operating losses, its total stock market capitalization reached \$4.2 billion, a level considerably above that of most well-established department store chains operating hundreds of stores. This level of valuation could be justified only under the most optimistic assumptions of revenue growth, profitability, and future business value. Such optimism was not warranted, given the brief operating history and still-to-be-proven profitability of the home shopping industry. The initial enthusiasm turned out to be significantly overblown. Although the company survived, only a year later the stock had dropped more than 90 percent from its all-time high.

The value of a company selling a trendy product, such as television shopping, depends on the profitability of the product, the product life cycle, competitive barriers, and the ability of the company to replicate its current success. Investors are often overly optimistic about the sustainability of a trend, the ultimate degree of market penetration, and the size of profit margins. As a result, the stock market frequently attributes a Coca-Cola multiple to a Cabbage Patch concept.

All market fads come to an end. Security prices eventually become too high, supply catches up with and then exceeds demand, the top is reached, and the downward slide ensues. There will always be cycles of investment fashion and just as surely investors who are susceptible to them.

It is only fair to note that it is not easy to distinguish an investment fad from a real business trend. Indeed, many

investment fads originate in real business trends, which deserve to be reflected in stock prices. The fad becomes dangerous, however, when share prices reach levels that are not supported by the conservatively appraised values of the underlying businesses.

Conclusion

Wall Street can be a dangerous place for investors. You have no choice but to do business there, but you must always be on your guard. The standard behavior of Wall Streeters is to pursue maximization of self-interest; the orientation is usually short term. This must be acknowledged, accepted, and dealt with. If you transact business with Wall Street with these caveats in mind, you can prosper. If you depend on Wall Street to help you, investment success may remain elusive.

Notes

1. The only advantage of closed-end over open-end mutual funds is that closed-end funds can be managed without consideration of liquidity needs since they are not subject to shareholder redemptions. This minor advantage does not offset the high up-front commissions charged to initial purchasers of closed-end fund shares.
2. If the last price fluctuation was upward, the next trade at the same price is called a zero-plus tick; short-selling may take place on a zero-plus tick.
3. Many Wall Streeters have a different view of short-selling. They believe that short-sellers are dangerous manipulators of securities prices, driving prices down for their personal financial gain. This prejudice against short-sellers is consistent with Wall Street's interest in maintaining high stock prices.
4. Program trading is an arbitrage activity in which the stocks in an index are purchased and futures contracts on that index are sold, or vice versa, in either event locking in a riskless profit.

3

The Institutional Performance Derby: The Client Is the Loser

Growing pools of retirement and endowment funds seeking sound investment outlets led to the most important development in the investment world over the last three decades: the ascendancy of the institutional investor. Unfortunately institutional investing has developed in ways that are detrimental to the returns generated on the money under management. The great majority of institutional investors are plagued with a short-term, relative-performance orientation and lack the long-term perspective that retirement and endowment funds deserve. Myriad rules and restrictions, often self-imposed, also impair the ability of institutional investors to achieve good investment results.

Several decades ago the financial markets were dominated by individual investors who made their own investment decisions. The investment world was then a simpler place; stocks, govern-

ment bonds, and high-grade corporate bonds comprised virtually the entire investment menu. That world was a cautious one, as memories of the 1929 stock market crash and the Great Depression that followed were slow to fade.

In the years after World War II, however, increasing pools of retirement savings in corporate pension funds created an opportunity for professional money managers to go into business. Total funds under management rose from \$107 billion in 1950 to more than \$500 billion in 1968, to approximately \$2 trillion in 1980, and \$6 trillion in 1990. Over the same forty years, the share of institutional ownership in all publicly traded U.S. equity securities increased from 8 to 45 percent.¹

Under the Employee Retirement Income Security Act of 1974 (ERISA) institutional investors were required to act as fiduciaries for future retirees by achieving acceptable investment returns with limited risk. Adoption of the prudent-man standard, under which pension funds would only make investments that a "prudent man" would make, was intended to ensure conservative management. Over time, however, the *modus operandi* of institutional investors began to diverge from what the statute intended. A 1979 U.S. Department of Labor ruling that the prudent-man standard applied to an entire portfolio rather than to the individual securities within it opened the door to portfolio-oriented investment strategies that ignore risk on an investment-by-investment basis. In addition, a great many institutional investors have been swept into the short-term relative-performance derby, an orientation inconsistent with the prudent-man test.

Today institutional investors dominate the financial markets, accounting for roughly three-fourths of stock exchange trading volume.² All investors are affected by what the institutions do, owing to the impact of their enormous financial clout on security prices. Understanding their behavior is helpful in understanding why certain securities are overvalued while others are bargain priced and may enable investors to identify areas of potential opportunity.

The Money Management Business

If the behavior of institutional investors weren't so horrifying, it might actually be humorous. Hundreds of billions of other people's hard-earned dollars are routinely whipped from investment to investment based on little or no in-depth research or analysis. The prevalent mentality is consensus, groupthink. Acting with the crowd ensures an acceptable mediocrity; acting independently runs the risk of unacceptable underperformance. Indeed, the short-term, relative-performance orientation of many money managers has made "institutional investor" a contradiction in terms.

Institutional investors are presumably motivated both by the ongoing challenge of achieving good investment results and by the personal financial success that accrues to participants in a profitable money management business. Unfortunately for investment clients these objectives frequently are at odds. Most money managers are compensated, not according to the results they achieve, but as a percentage of the total assets under management. The incentive is to expand managed assets in order to generate more fees. Yet while a money management business typically becomes more profitable as assets under management increase, good investment performance becomes increasingly difficult. This conflict between the best interests of the money manager and that of the clients is typically resolved in the manager's favor.

The business of money management can be highly lucrative. It requires very little capital investment, while offering high compensation and the rapid development of what is effectively an annuity. Once an investment management business becomes highly profitable, it is likely to remain that way so long as clients do not depart in large numbers. In the money management business management fees paid by new clients constitute almost pure profit. Similarly, lost fees resulting from client departures affect profitability nearly dollar for dollar, since there are few variable costs to be cut in order to offset lost revenues.

The pressure to retain clients exerts a stifling influence on institutional investors. Since clients frequently replace the worst-performing managers (and since money managers live in fear of this), most managers try to avoid standing apart from the crowd. Those with only average results are considerably less likely to lose accounts than are the worst performers. The result is that most money managers consider mediocre performance acceptable. Although unconventional decisions that prove successful could generate superior investment performance and result in client additions, the risk of mistakes, which would diminish performance and possibly lead to client departures, is usually considered too high.

The Short-Term, Relative-Performance Derby

Like dogs chasing their own tails, most institutional investors have become locked into a short-term, relative-performance derby. Fund managers at one institution have suffered the distraction of hourly performance calculations; numerous managers are provided daily comparisons of their results with those of managers at other firms. Frequent comparative ranking can only reinforce a short-term investment perspective. It is understandably difficult to maintain a long-term view when, faced with the penalties for poor short-term performance, the long-term view may well be from the unemployment line.

The short-term orientation of money managers may be exacerbated by the increasing popularity of pension fund consultants. These consultants evaluate numerous money managers, compare their performances, contrast their investment styles, and then make recommendations to their clients. Because their recommendations can have a significant influence on the health of a money management business, the need to impress pension fund consultants may add to the short-term performance pressures on money managers.

What is a relative-performance orientation? Relative performance involves measuring investment results, not against an absolute standard, but against broad stock market indices, such as the Dow Jones Industrial Average or Standard & Poor's 500 Index, or against other investors' results. Most institutional investors measure their success or failure in terms of relative performance. Money managers motivated to outperform an index or a peer group of managers may lose sight of whether their investments are attractive or even sensible in an absolute sense.

Instead of basing investment decisions on independent and objective analysis, relative-performance-oriented investors really act as speculators. Rather than making sensible judgments about the attractiveness of specific stocks and bonds, they try to guess what others are going to do and then do it first. The problem is that even as one manager is attempting to guess what others may do, others are doing the same thing. The task becomes increasingly intricate: guess what the other guessers may guess. And so on.

Who is to blame for this short-term investment focus? Is it the fault of managers who believe clients want good short-term performance regardless of the level of risk or the impossibility of the task? Or is it the fault of clients who, in fact, do switch money managers with some frequency? There is ample blame for both to share.

There are no winners in the short-term, relative-performance derby. Attempting to outperform the market in the short run is futile since near-term stock and bond price fluctuations are random and because an extraordinary amount of energy and talent is already being applied to that objective. The effort only distracts a money manager from finding and acting on sound long-term opportunities as he or she channels resources into what is essentially an unwinnable game. As a result, the clients experience mediocre performance. The overall economy is also deprived, as funds are allocated to short-term trading rather than to long-term investments. Only brokers benefit from the high level of activity.

Other People's Money versus Your Own

You probably would not choose to dine at a restaurant whose chef always ate elsewhere. You should be no more satisfied with a money manager who does not eat his or her own cooking. It is worth noting that few institutional money managers invest their own money along with their clients' funds. The failure to do so frees these managers to singlemindedly pursue their firms', rather than their clients', best interests.

Economist Paul Rosenstein-Rodan has pointed to the "tremble factor" in understanding human motivation. "In the building practices of ancient Rome, when scaffolding was removed from a completed Roman arch, the Roman engineer stood beneath. If the arch came crashing down, he was the first to know. Thus his concern for the quality of the arch was intensely personal, and it is not surprising that so many Roman arches have survived."³

Why should investing be any different? Money managers who invested their own assets in parallel with clients would quickly abandon their relative-performance orientation. Intellectual honesty would be restored to the institutional investment process as the focus of professional investors would shift from trying to out-guess others to maximizing returns under reasonable risk constraints. If more institutional investors strove to achieve good absolute rather than relative returns, the stock market would be less prone to overvaluation and market fads would less likely be carried to excess. Investments would only be made when they presented a compelling opportunity and not simply to keep up with the herd.

Impediments to Good Institutional Investment Performance

One major obstacle to good institutional investment performance is a shortage of time. There is more information available

about securities, as well as corporate and macroeconomic developments, than anyone could reasonably digest. Just sifting through the accumulating piles of annual reports, Wall Street research, and financial periodicals could consume all of one's time every day. Thinking about and digesting all this material, of course, would take considerably longer.

An investor's time is required both to monitor current holdings and to investigate potential new investments. Since most money managers are always looking for additional assets to manage, however, they spend considerable time meeting with prospective clients in addition to hand-holding current clientele. It is ironic that all clients, present and potential, would probably be financially better off if none of them spent time with the money managers, but a free-rider problem exists in that each client feels justified in requesting periodic meetings. No single meeting places an intolerable burden on a money manager's time; cumulatively, however, the hours diverted to marketing can take a toll on investment results.

Another difficulty plaguing institutional investors is a bureaucratic decision-making process. While managing money successfully is not easy for anyone, many institutional investors compound that difficulty with a tendency toward conformity, inertia, and excessive diversification that results from group decision making.

Any institutional investor with an innovative or contrarian investment idea goes out on a limb. He or she assumes a personal risk within the firm, which compounds the investment risk. The cost of being wrong goes beyond the financial loss to include the adverse marketing implications as well as the personal career considerations. This helps explain why institutional investors rarely make unconventional investments. It also shows why they tend to hold onto fully priced or overpriced investments, unwilling to recommend sale unless a consensus for selling has already emerged. The multidimensional risk from holding too long is usually less than the risk in selling too soon.

Selling is difficult for money managers for three additional

