INSTITUTIONAL INVESTING AND THE SECURITIES MARKETS

Remarks of Keith Funston, President of the New York Stock Exchange, at American Management Association Briefing Session, New York Hilton, November 16, 1966

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A very distinguished editor wrote not long ago that "business more than any other occupation is a continual dealing with the future; it is a continual calculation, an instinctive exercise in foresight."

The topic that brings us together today, the role of institutional investors in the securities markets, is eminently worthy of that perceptive description. In few realms of business endeavor does so much depend on dealing with the future and on the exercise of foresight. For in this vital aspect of the securities industry there is much at stake: first, the financial health of the investing institution itself; secondly, the economic welfare of the millions of investors on whose behalf the institutions make investment decisions; and, third, the fortunes of hundreds and thousands of companies whose securities are the chosen investment instruments.

What we are talking about is a most significant development in the art of putting capital to work -- the burgeoning of a sizeable segment of shareownership that can be called "collective capitalism." This is a term that can be applied to the growth in indirect investing by millions of individuals who turn over some part of their savings for investment by professionals through a variety of investing institutions. It supplements very constructively the basic method of investing which is, of course, the direct purchase of stock by individuals and which has been dubbed "people's capitalism."

We meet at a time when public interest in the role of institutions in the securities markets is probably at an all-time high. Hence, the millions of investors who use our markets directly, and the additional legions who have an indirect stake in the stock market, may be interested in some of the views of the Exchange about this phenomenon of "collective capitalism."

In discussing the subject let us be as specific as possible.

GROWTH OVER PAST DECADE

Eleven years ago, when the Exchange's views on this topic were presented to the American Life Convention at their annual meeting in Chicago, some of the challenges and problems that would be presented by the growth of institutions were foreseen. We then expected the institutions to enlarge greatly their role both in the stock market and in the economy as a whole -- and indeed they did -- "in spades."

Institutional shareownership of stocks listed on the New York Stock Exchange has grown from 15% of the total outstanding eleven years ago to 20% today. In dollar amounts, the growth is even more impressive -- from

$30 billion to $110 billion at the end of 1965. These figures do not include bank-administered personal trust funds because of the lack of good historical information. It is our estimate, however, that if bank-administered personal trust funds were included among institutions, the institutional total would have grown from approximately one-fourth of all stock listed on the Exchange in 1955 to about one-third of all stock presently listed.

In 1955, we estimated that institutions were investing on balance some $6 million a day in the stock market. By 1965, this had increased to roughly $20 million a day.

EFFECT ON INSTITUTIONS

The financial world today is a different place as a result of these developments.

First, the institutions themselves have undergone significant changes as they have grown in size and importance in the marketplace. The responsibility for bigger investment decisions has brought about a much higher order of "professionalism" among the analysts and executives who are responsible for portfolio management. But probably the most significant change, which requires the shedding of some old stereotyped notions about institutions, is the increased emphasis on common stock performance -- dividend yields and appreciation in value. This, of course, is a result of the competition among institutions for the public's funds.

As individuals and others become more aware of the benefits of good performance, they tend to place their funds with those institutions that show above-average success. For example, if the assets of a non-insured corporate pension fund increase substantially through capital appreciation, the company's contributions to the fund can be lowered over future years. Thus, more corporations are "shopping around" before investing their funds with a particular trustee institution or with an eye to switching trustees. And, more individuals are doing the same in their mutual fund selection. Consequently, institutions, in order to increase their share of the market, attempt to achieve above-average performance.

One of the ways in which they attempt to improve performance is through more frequent review of portfolios, through selling stock more often and reinvesting the proceeds in more attractive investment opportunities. This is indicated by the increased turnover rates in the past few years in institutional common stock portfolios.

For example, mutual funds -- considering both their purchases with new funds and their reinvestments -- increased their turnover rates from 16% annually in 1955 to 21% in 1965 and to 32% and 34% in the first and second quarters of 1966, respectively. A similar pattern of increase exists among pension funds and insurance companies, although the turnover rates are a good deal lower. Among mutual funds, the average turnover rate computed on a comparable basis currently exceeds the rate for all stocks listed on the Exchange, which has been around 18% so far in 1966. Turnover rates for pension funds and insurance companies are not substantially below this average rate.

Institutional holdings have, of course, worked significant changes in the character of the market. However, the market's most essential ingredient, namely its liquidity, has not been decreased appreciably, if at all. This is no accident. A lot of work has been done by member organizations and by the Exchange itself to gear the market for handling the challenges of institutional business -- and in a few moments I will discuss this in more detail. At this point let me say that the old idea that institutions might "dry up" the supply of stock by buying only for the long-term and selling only when the very long-term outlook deteriorates is one of a number of concepts that has to be re-examined.

It is already apparent that the increased emphasis on performance creates some new problems for the marketplace. Of course, efforts by a professional investor striving to improve the return on funds entrusted to his care are normal and are expected by his client. But we must remain watchful that the new stress on performance remains tempered by prudence. When the public entrusts its savings to an institution for long-term investment, it may be a questionable policy to subject these savings to the risks of short-term speculation, unless, of course, the investor is told before he puts up his money that this is the policy of the institution.

EFFECT ON CORPORATIONS

The corporations whose stock is owned by the institutions have, of course, become increasingly sensitive to these very important shareowners. While it is difficult to assign precisely a cause to every effect, the influence of institutions can be seen in several phases of corporate policy.

For one thing, corporations in general have been providing more and better information to their stockholders. Federal legislation and the programs of our Exchange have been important factors here. But, in addition, the insistence of institutions and of brokerage firms on having more knowledge about individual companies has encouraged significantly the increased flow of information. It is fair to say that financial analysts from the institutions and from the securities industry have been beating a path to corporate doors. A considerable dialogue has therefore been going on between the corporation and the investment community.

This is constructive and we at the Exchange have encouraged an "open door" policy by corporations for the benefit of stockholders -- as well as security analysts, financial writers and others who have a legitimate interest in the various factors affecting a company's business. But, of course, we also stipulate that a company should not give information to one inquirer it would not willingly give to another who had a warrantable interest and took the trouble to seek an answer.

Another of the broad effects that institutions have had on the corporate scene is the influence they exert for better management. In the vast majority of cases, institutions do not try to influence management directly. However, they have an indirect effect, since if they disagree with management, they can always sell the stock -- the ultimate penalty in the free market's testing of comparative values. In many companies, institutional buying and selling of the company's equity issue in the marketplace is carefully reviewed. Also, institutional analysts include managerial ability as an important factor -- perhaps the most important -- in their appraisal of an equity issue. Since managements are aware that professional analysts are evaluating their performance, this also serves to keep management on its toes.

Much is made by some viewers of the financial scene of the possible power that large institutional investors may hold over the companies in which they invest. Our own observations at the Exchange would indicate that institutional stockholders are interested mainly in a good investment, rather than in corporate control.

However, institutions cannot and should not avoid their responsibilities to make use of the rights and privileges they have as shareowners in a corporation. The passive shareowner who expresses criticism of developments in the company only by phoning his broker to sell the stock is not making his full potential contribution to the corporate process. Institutions, in particular, with their great reservoirs of knowledge and experience should be encouraged to assume their full responsibilities as stockholders or permit those responsibilities to be exercised by those for whom the institution acts. The corporate ballot is too valuable a right to be locked up in a file drawer -- unused.

From the institutions's viewpoint, I think it is unwise for an institution to own more stock in a particular company than it is willing to vote as issues arise in the affairs of the company. There are legal restrictions in this area applying to mutual funds and insurance companies, and many other institutions impose restrictions on themselves as to the maximum percentage of a company's outstanding stock they will acquire. For not only do they seek to ensure diversification, but they also recognize that domination of a corporation's affairs by one investor would not be in the long-run interests of the institution or of investors generally. In fact, some pension funds wisely pass common stock voting rights through to the fund's participants -- a policy that I think strengthens corporate democracy.

EFFECT ON THE EXCHANGE COMMUNITY

Service is the business of the Exchange Community. Therefore, as I have already indicated, the Exchange and its member organizations have made profound changes in order to handle better the increased institutional volume.

Our very extensive programs of automation have been speeded along by the wish to provide maximum service to these large investors, as well as to growing ranks of individual shareowners. Here I refer to such innovations as the 900-speed ticker, the Market Data System which automates handling of trading information from the Floor, the Central Certificate Service, Compared Clearance and Central Computer Accounting. The Exchange for some time now has had one of the largest computer service centers in private industry.

Our service to customers has also been improved by the consolidation of specialist units on the Trading Floor. There now are some 87 substantially capitalized units with a minimum of four men apiece, compared to over 130 units several years ago, some consisting of only one or two men.

Many member firms have established institutional departments, designed to take care of the special research and order handling problems of institutional investors. Some of these departments now specialize in block trading or block positioning. Because of the more sophisticated needs of institutional investors, the quantity and quality of research among member firms has increased and improved over the last decade. The Exchange itself has established its own Institutional Investors Department whose function it is to maintain continuous liaison between the Exchange and leading institutional investors. This new department has established personal contact with nearly 1,000 institutional executives at meetings in most major cities of the country.

Because of improved procedures, the Exchange is now handling a much greater volume of large blocks in the marketplace -- doing so more efficiently and to the greater satisfaction of customers. For the first ten months of this year, the Exchange auction market handled almost 3000 blocks of 10,000 shares or more,an increase of about 70% over the same period last year. Blocks accounted for 4.3% of total reported volume, up from 3.3% a year before.

EFFECT ON THE PUBLIC INDIVIDUAL INVESTOR

What has the growth in institutional shareownership done for the public individual investor? In our opinion, he has greatly benefited both directly and indirectly. For one thing, the growth of institutional shareownership and the indirect ownership participation of some 100 million people have certainly encouraged many individuals to become direct shareowners. Many people who first became indirect owners through purchasing mutual fund shares have become direct shareowners in individual corporations later on.

The public individual investor has also benefited by all the improvements in the marketplace as a result of the growth of institutions. The increased information from corporations has encouraged better quality research and security analysis among brokerage firms. This makes for a better informed investing public, including individuals, who are then able to make sounder investment decisions. Thus, the efficiency of the marketplace is increased as funds are channeled into more favorable opportunities. And the public is the beneficiary of this constructive competition.

EFFECT ON THE MARKET

A key question for the public is how the institutions have affected the market. Statistical evidence indicates that institutions usually have been a stabilizing force in the market. For example, in the May 1962 market break, institutions and intermediaries had net purchase balances during the sharp declines on May 28 and the morning of the 29th, when individuals were net sellers; while on May 31, when individuals were buying on balance and the market rose, institutions and intermediaries were net sellers. Data published by the Investment Company Institute show the same pattern -- not only were mutual funds net buyers in the market decline of May 28 and 29, 1962, but they were net buyers in almost every major market decline of the postwar period.

This stabilizing tendency has been repeated this year. According to SEC figures, the institutions as a whole were buyers on balance in the first and second quarters of 1966. Indeed, their purchase balance in the second quarter, when the NYSE Common Stock Index dropped by 5.1%, was the largest for any quarter of record.

The Exchange specialist system has been instrumental in helping the institutions to carry out their transactions in a fair and orderly manner. As you know, more than 90 per cent of transactions on the Exchange occur at no price change at all or within one-eighth or one-quarter of a point of the previous transaction. Occasionally, however, an institution makes a sudden decision to sell in one afternoon a large holding of stock that may have been acquired over a period of many months or even years. In such cases there can be a very sharp effect on prices. The auction market adjusts to such situations and has been handling most of them quite efficiently, but it is not often reasonable to expect the market to absorb a block of stock of that magnitude as smoothly as if the same amount were offered to the market over an extended period of time.

It is evident that the growth of institutional investing has increased the amount of competition among markets for stocks listed on the Big Board. For a number of years, up until a year or two ago, the Third Market grew modestly. Recently, its relative importance has declined from 4% of NYSE volume in the beginning of 1965 to less than 3% in the second quarter 1966. A more important competitive factor to the NYSE lately is the growth of trading volume in Exchange listed stocks on regional exchanges. Share volume on the six largest regional exchanges in NYSE listed stocks increased from 6.8% of NYSE trading in those issues in 1955 to 10.1% in 1965. Also, trading in NYSE issues by the six regional exchanges now accounts for 86% of their total volume compared with 52% a decade ago.

THE FUTURE

Such competition, of course, is a reflection of the growth in the investment business both currently and in prospect for the future.

How do we see the future role and influence of the institutional investor? For one thing, we expect that if institutional shareownership continues to grow at the same pace as it has over the past decade, institutional investors will increase their holdings of NYSE listed stocks from the current 20% of the total to 27% in 1975 and 30% in 1980. If we add personal trust funds administered by commercial banks and trust companies to this total, we can expect total institutional ownership to be approximately 40% ten years from now and greater in 1980. There is a strong likelihood that by sometime in the 1970's institutions and intermediaries -- including banks, mutual funds, pension funds, and others -- may well account for half of the Exchange's public volume. At some later point, the institutional percentage is expected to level off as the payments from pension funds rise faster than the inflows.

The growth rate of noninsured pension funds has been tremendous in the past decade, and even assuming that this growth rate slows down in the future, they will be by far the largest institutional type in 1975. Of the projected 27% of institutional holdings of NYSE listed stock, pension funds will hold about 15% of the total, and their projected volume will account for around 8% of the Exchange's total share volume as compared to about 5% today.

The Exchange welcomes this institutional growth. Yet, at the same time, I must stress how important it is that the number of individual investors continue to grow. We think this is important not only to maintain "balance" in the marketplace, as between individuals and institutions, but also for a broader reason. Direct ownership of securities gives people much stronger and more personal identification and participation in the free enterprise system, on which this nation's prosperity is based. Therefore, in the national interest this form of people's capitalism must be encouraged.

The marketplace must be operated, therefore, in such a way that the big stockholder -- be he an individual or an institution -- does not have advantages or privileges obtained at the expense of the small stockholder. The liquidity of the marketplace requires both small and large transactions for its nourishment. It requires customers with varying objectives, motives and views. It must be truly broad and diverse.

The record of the past 15 years in broadening shareownership among individuals is very encouraging. Since 1952, the number of individual shareowners increased from $6\frac{1}{2}$ million to well over 20 million today. If both real income and the number of middle-income persons -- where most new investors come from -- continue to grow at the same rate as in the past decade, the number of individual shareowners will increase to more than 30 million by 1975. That number would provide the kind of balance to which I referred. For a sound market is one that is not dominated by any one category of investors.

On the way to the future, however, there are difficult policy decisions that must be faced. Some have to do with the nuts and bolts of intra-industry relationships. Others touch on the dollars and cents of such matters of broad public interest as the commission structure and commission rates.

Several of these matters are of particular interest to institutional investors and are being examined by the Exchange, by others in the industry, and by the SEC. While it would be presumptuous to attempt to anticipate the eventual solutions, two of the problems perhaps deserve special mention.

The question has been raised in some quarters -- whether it is wise for institutions or their affiliates to become Exchange members.

On our Exchange, institutions are not eligible for membership as the Constitution prohibits the ownership of voting stock in a member organization by anyone other than individuals who are active in the securities business and devote the major portion of their time to the business.

However, even apart from the existing constitutional bars, I doubt that institutional membership is in the best interests of the nation's shareowners - or the institutions themselves.

To my mind, it makes little sense for one class of customers, regardless of size, to be afforded the privileges of membership. If a person can meet the requirements of membership and wants to engage in the securities business - FINE. If a person is a customer -- even a very good customer -- and this is his only interest in the securities business - GREAT! But this does not mean that because he is a good customer he should, per-se, become a member.

This is particularly true when one considers that institutional membership on the Exchange may in the long run have the result of making markets less liquid; of increasing costs to small investors; of narrowing - not broadening - shareownership; and of upsetting the vital balance of participation between institutions and individual investors. As such it would be clearly inimical to the public interest and to the long-run interest of the nation's institutions themselves.

All customers, both individual and institutional, must have equal access to the central marketplace and access on equal terms. To give a big institutional customer a preferential break over Aunt Jane would offend the public interest.

Another question of broad interest to investors, a question that is under current discussion, is the subject of rate structure and minimum commission rates.

We look upon commissions from two points of view. We regard them, first of all, as compensation for services rendered by member organizations; secondly, we regard them from the customer's point of view as a price he is asked to pay for those services. Commission rates must be equitable from both points of view. From the member organization's standpoint, we believe that the commission structure must be such as to yield, over the long run, an adequate profit to the well-managed member firm. Over the past five years the average return on commission business was 3.7% after taxes, with one in five firms in 1965 losing money on this commission business. Such an unsatisfactory result certainly provides no leeway in the commission structure for any overall reductions in charges. Therefore, discussions of volume or quantity discounts or any other adjustments which will result in reducing the overall income of member firms, must concurrently consider a compensating increase in revenue in some other area.

By the same token, the commission structure must be fair, considering the service rendered, to those who pay the bills. It must be equally fair to small customers as to large ones. To repeat the thought expressed earlier with respect to institutional membership and access to the marketplace, to give a big institutional customer a preferential commission break over Aunt Jane, would be to offend the public interest. Any change in the commission structure must necessarily take into account the needs of investors -- individual and institutional, large and small, must consider the needs of the member firm community, and must satisfy these needs in a manner which is equitable for all.

As you know, last year the Exchange did a study projecting the possibility of tremendous advances in all segments of our business by the year 1975. These growth patterns have a bearing on the work of the Exchange's committee which has been studying the commission problem for some time. They also have a bearing on the conclusions and decisions which the SEC is expected to disclose in its forthcoming mutual fund report.

The future, therefore, points the way to continuing change which will inevitably have an impact on the traditional commission structure. Accordingly, the Exchange fully recognizes its primary responsibility to point the way with respect to changes in commission structure and rates. In the course of the next few months we hope to offer constructive conclusions for a commission structure and rate level which will help achieve the full growth potential which the future promises for this industry.

In our view, the basic consideration in making decisions on the commission question and other problems facing the securities industry must always be to preserve the liquidity, convenience, accessibility and centrality of the marketplace. The reason the Exchange has served institutions and the general public so well in the past is that, throughout its 175 year history, it has guarded well the hallmark of a great marketplace -- the capacity to bring together the maximum number of buyers and sellers in a single market. I am sure that in the future this will continue to be the paramount consideration. It would be folly for the Exchange ever to let habit, custom or inflexibility toward existing rules stand in the way of continuing to fulfill its role as the leading and most effective securities marketplace in the world.

Even though as a businessman I make no claim to have acquired any special skill in that "instinctive exercise of foresight," which I quoted earlier, it does not take an expert in this area safely to predict that the Exchange will continue in the future to provide a securities marketplace to match the needs of America's dynamic and growing economy.