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THE INDIVIDUAL INVESTOR AND THE STOCK MARKETS - - SOME OBSERVATIONS

An Address by

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Securities and Exchange Commission

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WOMEN INVESTMENT BROKERS

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No doubt you have many problems on your minds which we can discuss during the question period, when I will be pleased to do my best to explain the Commission's thinking on the many pressing problems of the securities industry. To get the conversation going, however, I have prepared a few remarks relating to the individual investor in today's equity markets. It is commonly observed that during the last few years, individuals have withdrawn from direct investment in stocks to an extent that is damaging in several directions.

There seems to be no question that substantial withdrawal by individuals has occurred and is continuing, although statistically this seems to have taken the form not so much in selling out as in not putting new money in. The aggregate number of individual holders of shares of listed companies has in fact gone down, but not as sharply as the amount of individual trading. It seems clear that the amount of new money being invested by individuals in corporate shares is clearly down.

Why is this bad, and for whom? I think that we must recognize that for any specific individual, it may not be bad. One cannot say categorically that it is always better for all persons to put their savings in stocks. On the other hand, it has clearly been bad for broker-dealers because of the loss of revenues. And it appears to be bad for industry generally to the degree that it has contributed to the lack of adequate markets for raising new equity capital, not only because prices are down but also because there is sparse demand even at low prices.

To what extent does this amount to a public problem, something that should be of concern to the federal government in general and the Securities and Exchange Commission in particular? The level of trading volume, broker-dealer revenues and stock prices, per se, have not traditionally been regarded as any direct concern of ours, at least in the absence of any indication that they are the effects of illegal activity. We have been officially indifferent to the relative prosperity of broker-dealers so long as they don't go broke in a manner that hurts their customers.

This official indifference, however, becomes inappropriate in the face of the possibility that the entire industry might collapse. It seems self-evident that our economy needs a healthy securities industry, whether or not it requires that any given person or firm remain in the industry. And, whether or not it is any of the government's business whether the stock market is up or down, still less whether any given stock is high or low, it becomes a public problem where depressed prices and activity threaten the ability of American industry to raise capital. Many observers argue that we are approaching these danger points. Even with due allowance for the manic-depressive propensities of Wall Street, we are taking these warnings seriously.

I do not accept the idea that the withdrawal of the individual investor is the cause of these undesirable developments, but I do accept the proposition that it is a cause. I am also aware of the chicken and egg aspect of the problem. But whether the individual left because the market went down or vice versa, the question worth pondering today is why does he stay away. Why does he show so little interest in stocks which, by all traditional standards, are fantastic bargains? Unlike the 1930's, we know it is not for lack of cash.

Some observers argue that, quite apart from market levels, intermediation - - as the bankers like to call it - - is the long range trend in our equity markets, if only because of the declining need for individuals to invest for retirement and estate-building purposes. Pension plans, medical insurance and the like are enabling more and more individuals to regard any excess cash on hand as money to play with, so to speak. Accordingly, they look forward to professionally managed equity portfolios as the only important future source of equity capital.

While the trends upon which this view is based cannot be denied, it would seem to me a most unfortunate development if large, professionally managed funds controlled the availability of equity capital. It might not matter so much to the very large corporations, but it could matter a great deal to smaller companies seeking to grow and needing investors willing to take chances beyond those permitted to a prudent man.

We at the Commission are not ordained economic prognosticators, and we enthusiastically deny any such talents. But since any further discussion of individuals in the stock market becomes fruitless if we assume that he is inevitably disappearing as the result of ineluctable forces, I will assume that he is not, which I hope is the case.

Let us, then, look at some of the other reasons why the individual has lost interest in direct equity investments and then consider what, if anything, might be done about them.

One obvious reason is that a lot of people lost a lot of money not too long ago, and the memory of this is still clear and bitter. Presumably this is curable by the passage of time if other reasons for hope appear. It is even possible in some cases that the shock of the great bear market has produced a more debilitating impotence on salesmen than on customers.

The other day I had an interesting conversation with a middle-aged salesman with a major firm, who related that he had recently called a customer of long standing whom he had not called in a long time out of embarrassment and the assumption that the customer would not welcome a call. To his surprise the customer chided him for his neglect. This led my friend to investigate a bit around the shop, and he concluded that the salesmen with primarily individual accounts who were in their prime in the 1960's were still numb and not doing so well. The younger fellows, however, who had never known an easy market, and therefore not knowing any better, were trying hard and, on the whole, doing better.

Obviously, I am not arguing from this that all that is needed to get the individual back into the market is more selling effort. But it could be that bad memories and all the public talk on the subject have made the problem worse than it need be.

Inflation, of course, is universally regarded as at least a contributing factor. Some argue that when both the rate of inflation and the prime rate exceed ten percent, stocks will remain hopelessly unattractive as investments and one need look no further, to understand why people are not eager to buy them.

Needless to say, these elements are far beyond the competence of the SEC as to remedial action. If this argument is correct - - and there is much to support it - - then efforts to correct other sources of investor disenchantment must be regarded, at best, as preparatory. That is to say, they are measures to make the markets attractive when, and if, the rate of inflation and the prime rate come down off the ceiling.

The other factors asserted relate generally to confidence in the fairness and efficiency of our markets. In his report of last February to George Schultz, then the Secretary of the Treasury, Professor Lorie had these things to say* - -

> "The overriding objective of public policy is to make our capital markets function more equitably and efficiently so as to reduce the

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* Lorie, Public Policy for American Capital Markets, February 7, 1974.

> cost of capital for American enterprise and increase the likelihood that capital will be channeled into its most productive uses. This objective can be fostered by insuring that our securities markets operate to achieve maximum efficiency in determining prices of securities and in effecting the transfer of ownership of securities. Moreover, attainment of this public policy objective requires the achievement of equity in relationships between individual investors and institutional investors."

Along with the stock exchanges and the NASD and the accounting profession, we are carrying on the campaign to increase the investor's confidence that he or his advisor has access to all material information about stocks as nearly as may be on a parity, both as to quality and time, with the institutional investor - - to put to rest as far as humanly possible the oft-repeated observation that the individual investor is the last to know. We want to make it untrue, and to convince people that it is untrue, that the individual investor is inevitably a patsy, at the mercy of the insider and the institutional investor with secret information. This is a game we know how to play, and I think we are making progress.

The efficiency of our markets to handle large transactions without abrupt price fluctuations is another matter. Popular critics of our markets have been fond of describing the modest investor who went to work in the morning with his portfolio in good shape and came home to dinner to discover that his life savings had been wiped out - - not because anything had happened to the company whose stock he held, or to the industry or the economy, but because some pension fund decided to unload, which triggered other institutional sheep to follow, and the market had been shattered.

To reduce the actuality and the fear of such a calamity, and because the selling institutions don't benefit either from such events, we know that it is desirable to provide more adequate markets for large trades. To the extent that this requires specialists, block positioners and third marketmakers to have more available capital, we have no direct remedy in mind. We do, however, think that the central market system will provide greater access by would-be large sellers to all potential marketmakers. It will also permit the individual investor to participate in certain trades if he has an appropriate outstanding limit order, just as he does now with the specialist, regardless of where the transaction occurs. In general, the central market system will give the individual investor access to the best price for his purchase or sale anywhere in the system. We think this should help.

We have not so far seen the virtue in proposals that would seek to reduce the price threat of large trades by limiting the holdings of institutional investors or limiting the amounts that can be sold in a given period of time or the extent to which the market price may move in a given day. It may be that some relief could be provided by devices of this nature, but we have yet to see a convincing proposal. We would, so far, rather concentrate on the other side, and develop markets better able to absorb large trades, with individual participation.

Finally, I should mention transaction costs, meaning primarily commission rates. At a meeting in Denver the night before last, I was once more accused of conspiring to drive the individual investor out of the markets by permitting his commission costs to go up, while permitting those paid by institutional investors to go down. With the advent of fully unfixed commissions next May Day, it is asserted, this discrepancy will be even greater and the individual investor will be even scarcer and his broker will be even broker. This charge carries the express or implied assumption that a system of fully fixed commissions such as we used to know would provide for artifically low rates on small trades which would be compensated for, or subsidized by, artifically high rates on larger trades.

I do not deny that that is how the system seems to have worked for many years. It worked best in those comfortable days when most firms actually did not know that they were losing money on small trades and institutional investors had not learned about customer-directed give-ups and similar games. But this awareness is now with us and we cannot take it away. I cannot believe that the individual investor will be well served by the brokerage industry as a whole so long as it is conscious of losing money on his business. We might, of course, try to force the broker to service small trades as compensation for higher fixed revenues from larger trades, but treating the broker-dealer industry as a common carrier raises unattractive spectres that I am sure the industry as a whole would deplore.

We think the individual investor as a class will be better served if his business is profitable to his broker. If this means that, on the whole, his transaction costs must go up, then they will. While the evidence on the elasticity of demand relative to rates is not terribly clear, there is good reason to believe that higher rates will not deter the individual from returning to our equity markets as a direct investor, if other conditions are favorable, and if he is welcomed, indeed courted, by his broker with genuine enthusiasm.

It should be noted that the other elements of total transaction costs, namely, clearance and transfer charges, should go down relatively as the moves toward integrated, nation-wide clearing and depository facilities near completion.

I should add a word about taxes, even though, fortunately, taxes are not our business. It is possible that the increases in the maximum long-term capital gain rate, especially when combined with the maximum overall individual rate and high interest rates, has had an adverse effect on individual trading. There has been a variety of proposals for modification of the capital gain treatment to remove a major inhibition against portfolio readjustment, especially by older persons sitting on long-held low basis stock and contemplating estate planning. One such proposal is pending now in a bill submitted by Senator Bentsen of Texas. The New York Stock Exchange sponsored a study concluding that capital gains provisions encouraged rather than discouraged trading and could result in a net increase in tax revenues.

We feel somewhat inhibited about intruding into tax policy and we have not yet had occasion to take an official position on any of these proposals. It should be no secret, however, that we would welcome tax provisions that encourage individual trading if such provisions can be made consistent with overall government tax policy.