

Overview

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Any speaker on an "overview" panel is faced with a dilemma: Should he try to summarize the remarks of previous speakers, attempting to discern a consensus? Should he attempt to evaluate conflicting proposals, advocating those he finds appealing? Or, should he try to provide a different and perhaps unifying perspective on the issues?

My remarks combine all three approaches, but my primary effort is to provide a different perspective on what has been happening in the financial markets, specifically in the equity markets. I view the events of last October as a symptom of a larger problem, as an important step in an evolutionary process. And, as I view that process, I am reminded of Adam Smith's "invisible hand" and of the process of creative destruction that Joseph Schumpeter described.

I have labored in the trenches of the equity and equity options and futures markets for 20 years. I believe that I see and understand the trees from everyday contact. I leave it to you to judge whether I can see the forest. While I acknowledge that there are some structural changes that would help my business, I believe that I have avoided any urge to give in to parochial interests. If you find my description of the markets to be accurate, the policy implications will seem obvious.

The significance of October 19

October 19, 1987, has become the most completely dissected and

analyzed day in the history of world financial markets. However, for a thorough understanding of what happened that day, we need to look at changes in the stock market that have been evolving for some time rather than pinpoint a particular trigger.

Why has there been such an incredible proliferation of options and futures? Why has the movement to alternative trading strategies accelerated? Indexation, portfolio trading, and electronic trading systems all are trying to tell us something about the structure of the market.

On October 15 of last year, at an evening **speech** to 70 pension plan sponsors, Dr. Henry Kaufman spoke about the potential for "lurches" in the equities markets, fixed-income markets and currency markets; that is, for substantial movements to different price levels with very little trading activity. This timely warning foreshadowed our principal concern about the equity market decline of 1987—that it was so abrupt, not that it went down. Secondary to this is why the market went so high. I believe that these events are a manifestation of an incomplete transition to a new equity market structure.

The year, 1987, marked the end of a 13-year bull market, which had been a unique period in American history. In the 1960s, most pension fund assets were managed in balanced accounts. With the help of pension plan consultants, sponsors began to select specialized active managers for their equity assets and, eventually, for their fixed-income assets, as well. In the early 1970s, the pension officer emerged as an investment manager; he was no longer simply an administrator. Consequently, we saw the concentration of equity assets in fewer hands, creating a new structure that was slower to respond to dramatic changes in price.

The speed of communication—electronic data and verbal **communication**—meanwhile accelerated the exchange of information. We've seen the traditional swings between optimism and pessimism compressed into very short periods of time, and we've seen markets go too far in both directions. Futures have facilitated the linkages between markets, encouraging globalization.

In 1987, we believe that the market approached its private-market value: The **S&P 500** was trading at three times book value, yet over the past 80 years, it had generally traded in a range of one to two times book value. The **price/earnings** ratio on trailing earnings in 1987 peaked for the post World War II period, and dividend yields

reached their lowest levels in 60 years, or since the third quarter of 1929. In August and September, we began to see a substantial change in the way that people perceived equities. Finally, the market moved from its private-market value to the high end of its traditional valuation range *after* the October break.

Changes in asset allocation

As the traditional role of investment managers changed from full-spectrum investment advisers to equity specialists or fixed-income specialists, investment horizons shortened.

Today, most active equity managers avoid market timing. Their stated policy is to stay as fully invested as possible. This approach is dictated by their employers, the plan sponsors, because pension plan sponsors want to control asset allocations.

A few years ago, plan sponsors discovered residual, unwanted cash in their accounts. These unintended cash balances naturally interfered with the plan's asset allocation objective. One multibillion dollar pension plan now allocates 105 percent of its normal commitment to equities as one way of dealing with residual cash. The plan administrators conducted a survey and found that they always ran about 8 percent "extra" cash. So the plan simply hired another manager to invest the residual cash that was already allocated to other managers. Another development was the creation of sweep funds by the banks, which swept unintended cash into a separate fund where stock index futures were used to equitize that cash. Instead of the short-term money market return, the plan received an equity market return. Until recently, few managers needed to be tactical asset allocators. We estimate that pension fund assets in tactical asset allocation programs were 1 to 2 percent of total assets in early 1987. The four largest asset allocators were all more than 90 percent in bonds in the summer of 1987.

In addition, many users of portfolio insurance had really become closet market timers. They were unwilling to commit to selling stocks because of the often hard philosophy that they'd never met anyone who could time the market successfully over numerous market cycles.

The portfolio insurers had a plan, as well. It had the vulnerability of any stop-loss strategy, but it was a clearly defined plan. Unfor-

tunately, the buyers had no countervailing plan. In fact, structural inhibitions, as I mentioned, left most would-be buyers without a strategic reserve. In the week of October 19, we saw some very sizable buying, but not from the active managers, because they had no cash. They were fully invested by mandate or couldn't respond. The tactical asset allocators, however, bought more than \$7 billion in stocks.

The decline in liquidity

The traditional providers of liquidity in the marketplace had been the specialists and the block traders. They had suffered during the 1974-87 period from a dramatic diminution in their margins because of the contemporaneous decline in commissions. These firms have gradually shifted assets, both capital and human, away from block trading. The ad hoc joint venture between the block trading houses and the specialists that evolved from 1965 to roughly 1985 is being disbanded. The reduced profitability of the secondary trading of stocks, as distinguished from the new issuance of shares, is unique in Wall Street history.

This shrinking profitability is causing the marketplace to seek alternative structures to find the liquidity needed by the increasingly concentrated holders of stock. The policy that forced negotiated rates and encouraged the use of commissions to buy goods and services from nontraditional sources other than the securities houses is having a dramatic effect on the structure and composition of the resources dedicated to facilitating this secondary trading of stocks. We are not complaining about these changes, though. We have the flexibility to adjust to these new equity market structures.

My purpose today is to alert you to what may be the unintended consequences of moving to a deregulated commission environment, where large financial entities are causing basic structural changes in the way securities are traded in the United States. These changes were never intended by the Congress, the Securities Exchange Commission or the U.S. Department of Labor. Furthermore, the volatility of the markets and the events of October 1987 are both manifestations of this incomplete **restructuring** process. I believe that the market is trying to substitute alternative methods of trading within the traditional framework of the exchanges. I suggest that we view the pro-

liferation of alternatives—options, futures, electronic systems, portfolio trading, one-price auctions, and excessive volatilities during periods of stress—from this perspective.

The decline of commissions

After a number of modest changes in commission rates which began about 20 years ago, fully negotiated commission rates were implemented in 1975. A transaction that would have brought a brokerage firm \$0.40 a share in the 1960s might bring in less than \$0.04 a share today. The fixed commissions of two decades ago were used to pay for the traditional services of the securities houses. Today, an investment manager can use commissions almost like cash to buy nearly anything he needs to **run** his business. We believe that approximately one-third of institutional commissions are committed to soft dollar purchases of goods and services, other than traditional brokerage firm research and ***the ongoing commitment of capital for liquidity when needed***. At least one major institution uses 70 percent of its commissions for the purchase of goods and services from alternative sources. These commissions are never "recycled" through the block trading mechanism, and they are not available to provide liquidity when it is needed.

The decline in commission rates was accompanied by a dramatic surge in volume, which has temporarily obscured the substantial changes in the traditional methods of trading equity and providing liquidity. This is understandable. As the cost of trading declined, investors and investment managers became more willing to trade in response to modest shifts in company or industry prospects. The increase in volume, combined with declining revenue per unit and the inexorable growth of expenses, has led to dramatic changes. Twenty years ago the commission brokerage business was profitable. Today, secondary trading of equities is ***not*** a significant source of profits for any major securities firm. For years, the dominant source of earnings for brokerage firms dealing with the individual investor has been profits from interest charges or credit balances in margin accounts, but institutional firms lack this cushion. Currently, most institutional firms use equity sales, research and trading to support other businesses. Deteriorating profitability of the basic brokerage

business explains the redeployment of resources away from secondary trading and block trading to new security issues, mergers and acquisitions, and leveraged buyouts. These new activities, together with specialized securities services such as asset management, arbitrage and derivative trading, have become the major profit sources.

Higher commissions in the past may have *discouraged trading* activity, but they also provided a *kind of insurance*. Block traders and exchange specialists had incentives to make bids and offers that would stabilize the market. At old commission levels, they could *afford to provide liquidity during periods of stress*, even if it meant losing money on a specific trade. They relied on the financial incentives of a historic and future flow of commissions at a profitable level. At current levels of commissions, however, the financial incentive is insufficient to cover the risks of significant block positions. A block trader cannot afford to lose money on even a few trades. Likewise, the specialist has seen a sharp drop in his floor brokerage. In the early 1970s, about two-thirds of the typical specialist's income came from floor brokerage and the balance from trading. In 1983, the relationship was reversed, with two-thirds of income from trading. Although more recent figures are not available, we believe that this trend has become even more pronounced.

During past market breaks, the public has expected Wall Street to come to the rescue. In 1987, announcements of corporate stock **buybacks** were the functional equivalent, because reduced profitability rendered general market support from brokers impractical. Salomon Brothers and other firms offered to stand with the specialists on difficult openings and reopenings, but the impact of this effort was limited. New York Stock Exchange specialists in the aggregate had approximately \$1 billion in capital on October 19. While their historic return on capital has been excellent, this capital is not a meaningful contribution to liquidity on a day when nearly \$25 billion in stock is changing hands on the New York Stock Exchange. At low commission levels, block traders and specialists cannot *accumulate a cushion* to provide the liquidity that is essential for smoothly functioning equity markets during periods of stress.

It is interesting to contrast the ability of the U.S. securities industry to respond to the demand for liquidity with the corresponding response in Japan. Japanese brokers were a major stabilizing factor last October, partly because high fixed commissions have been retained in

the system. Although the profits of Japanese brokers come from sources as diverse as in the United States, the secondary trading of Japanese equities is highly profitable. Average commission levels on large trades are between five and 10 times U.S. levels. Nomura Securities, the largest Japanese broker, has a market value larger than that of any U.S. company other than IBM and Exxon and larger than all the U.S. brokers combined.

It is tempting to use the Japanese experience to illustrate another point: the impact of volatility on the corporate cost of capital. I doubt if our price/earnings multiples or capital costs would approach Japanese levels even if volatility disappeared completely, but there are clear theoretical and empirical relationships between volatility and cost of capital. Lack of liquidity and consequent volatility reduces the effectiveness and raises the cost of the capital-raising mechanism. In describing this situation, I am not hinting that we need regulations or legislation to restore our profitability or that we should return to fixed rates. I am simply describing the reality of a powerful trend.

New providers of liquidity

As Adam Smith would have predicted, new providers of liquidity are springing up. In contrast to Frank Edwards, I believe that the locals or floor traders in the futures pits make an important contribution to liquidity; but I certainly concur with Frank that they cannot do the job alone. Fortunately, different types of economic incentives have attracted other traders, including firms that perform option and futures arbitrage both domestically and internationally. GLOBEX, SOFFEX, INTEX, and screen-based trading in Japan are alternatives to the exchange floor system.

Portfolio trading

Just as asset allocation strategies of various kinds have grown in popularity, major institutional investors of all stripes have changed their trading policies. They have responded to the changes in market structure, to the changes in transaction costs, and to the fact that investors who have focused on individual stock selection have not been conspicuously successful in recent years. Indexing in various

guises has become increasingly popular. Indexing is the creation of a fund designed to track one of the popular stock market indexes, most commonly the **S&P 500**. The growth of indexing and asset allocation and the relative decline of stock selection have led to a shift in emphasis among institutional managers from block trading to portfolio trading. The ad hoc joint venture between the block positioning firms and the exchange specialists that worked well during the past two decades in handling block trades cannot meet the need for portfolio trading in the present environment. Exchange rules prohibit member firms from trading portfolios *as portfolios* during normal market hours.

Consequently, trades are executed in individual stocks or portfolio risk is adjusted in the futures markets. Portfolio trades do occur offshore, outside normal U.S. market hours. As Adam Smith would have predicted, if a market structure will not adapt, a new market structure will be created. Exchange rules have not only forced portfolio trading into the futures markets and offshore, they have encouraged a massive reallocation of personnel and capital in response to changing market structures. More and more U.S. equity trading is taking place away from the New York Stock Exchange floor. Some of the volume is going to the third market or other exchanges, and some is going outside the United States. The success of the U.S. stock index futures markets is, in substantial measure, due to the demand to trade portfolios or portfolio risk packages combined with the reluctance of the older marketplaces to meet the need. Barring dramatic rule changes, the trend away from the New York Stock Exchange is inexorable. The securities industry cannot stop it. U.S. regulators cannot stop it. The marketplace is adjusting to the incomplete transition away from the traditional providers of transaction liquidity and moving toward a new structure.

Although the interest equalization tax was the proximate cause of the development of the Eurodollar markets, a substantial contributing cause was the inflexibility of U.S. securities regulation. When offshore security markets were undeveloped and unsophisticated, U.S. regulators could make rules that applied worldwide. They no longer have that luxury. October 19, 1987, illustrated the impact of an unrealistic demand for liquidity on a market structure that has not evolved to the point where new providers of liquidity are in a position to offer sufficient liquidity.

What are the policy implications?

Despite the Brady Commission's more narrow focus on October 19, its recommendations are generally appropriate, though occasionally committed to slowing down inevitable changes. If my view of what is going on in the marketplace is correct, we are in the middle of a massive market-driven restructuring of the financial markets. The creative destruction of the capitalist system which Schumpeter described is building a new structure to meet needs that were not envisioned as recently as 10 years ago. The regulatory and policy implications seem clear. The concept of deregulation in the United States has restored vitality and initiative to corporate America. Yet, it is an open question whether a highly regulated industry can go from fixed prices to open competition without concurrent deregulation in other areas. These are tough political issues for which we see no support for slowing or reversing the trend. Turning back the clock on negotiated commissions is politically difficult. The only feasible choice is to remove regulatory obstacles to the development of a new market structure. As long as these obstacles delay the still incomplete restructuring process, volatility will be a problem.