

A REGULATOR'S LOOK AT QUICK PROFIT  
FEVER -- SOME DISQUIETING REACTIONS

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In 1961, the high level of investor interest in new stock issues led Keith Funston, who was the President of the New York Stock Exchange, to observe that "some would-be investors are attempting to purchase shares of companies whose names they cannot identify, whose products are unknown to them, and whose future is at best highly uncertain."

Both before and since the hot issue market of 1961, there have been investors who have pursued what has been called the "bigger fool" theory of investing. There comes a time, of course, when the latest fool places his sell order only to find that buyers are unwilling to take the stock off his hands at anything approaching the price he recently paid for it. We have little sympathy for the speculator caught in the shakeout. We are concerned, however, for the unwary who are victimized by those who persuade them that the securities markets are a place to make a quick buck.

There are some disturbing signs that we may be on the threshold of another hot issue market. While it has been said that history does not repeat itself, there is once again some evidence that issuers whose names end in the syllables "-tronics" or "-sonics," and other sounds which seem to suggest waves of the future, are being grabbed up by the public at substantial premiums over their offering prices. In a recent instance, a registration statement which became effective on September 5, 1967 contained an Income Statement showing that for the six-month period ending May 31, 1967; the issuer had earnings for the first time in its history. Within 10 days of the effective date of the registration statement, the underwriter and issuer decided to withdraw the offering, cancel all transactions, and bring to the Commission's attention facts that had not previously been disclosed -- that the company had operated at a loss in June and July of 1967. By the time this action was taken, the entire offering had been sold out at the offering price of \$22.50 per share and active trading was in progress at prices up to \$49.00 per share. As a result of the cancellation, no securities were delivered and no transactions were consummated.

This case primarily illustrates the adverse consequence that can result from the failure to amend a registration statement in a timely fashion. But it also is an example of the extent to which the public, when prone to speculate, will disregard the considered judgment of both the issuer and underwriter as to the approximate worth of the securities.

These matters are all too reminiscent of the experience of six years ago. They suggest that perhaps the only thing we learn from history is that nobody learns anything from history.

This audience, however, need not be reminded that the aftermath of hot issue markets can be disastrous for those in the investment banking business as well as for investors. In most cases, severe losses were sustained by

those who invested in and, as of May 28, 1962, still held those hot issues. Following the May 1962 market break, the over-the-counter market went into doldrums from which it is only now -- some five years later -- beginning to emerge. And in that aftermath, the market for common stock underwritings also suffered for a long time. I am confident that the investment banking community will put its best foot forward in attempting not to encourage another major hot issues market with its inevitable aftermath.

I should make clear that, absent fraudulent and manipulative practices, speculation in the securities markets has never been viewed as unethical or opprobrious. In enacting the Securities Act of 1933 and the Exchange Act of 1934, the Congress recognized, however, that excessive speculation accompanied by considerable price gyrations can be detrimental to the national interest. The Exchange Act established certain controls over securities speculation. In Section 7 it vested in the Board of Governors of the Federal Reserve System power to regulate the amount of credit that may be initially extended on any security registered on a national securities exchange. By adjusting the amount of bank credit available for securities transactions, the "Fed" can attempt to moderate the tempo of price fluctuations in securities markets. Moreover, the Commission is authorized by Section 10(a) of the Exchange Act to prohibit or limit short sales of securities or the use of stop-loss orders. By all counts, these governmental powers and other regulatory authority contained in the Federal securities laws have been used judiciously to maintain public confidence in the securities markets. Our aim over the years has been to exercise the minimum amount of regulation of the securities markets consistent with the public interest and the interest of investors.

Speculation in the securities markets has long attracted the attention of the Securities and Exchange Commission. Until recently, our activities in this respect have primarily been directed toward uncovering situations in which fraud and manipulation are present or in which the absence of adequate information would provide the take-off point for such activity. Most recently, however, we have viewed with great concern certain new developments in the securities markets. One of these developments is short-term trading by a number of professional investment managers. Illustratively, financial institutions effected \$11.4 billion of common stock purchases and sales in the second quarter of 1967, a new record. This compares with a quarterly rate of \$8.1 billion in 1966 and only \$3.1 billion in 1962. In our Report of Public Policy Implications of Investment Company Growth we called attention to the following facts. I will not belabor you with more statistics, but in sum the facts are these:

1. The percentage of all corporate stock held in institutional portfolios has risen at a rapid rate.
2. Among institutions, increases in the stockholdings of investment companies and, most recently, of non-insured pension funds have been striking.
3. Institutions and institutional intermediaries account for a much larger proportion of trading volume in securities than their holdings alone would indicate.

4. Public individuals' share of trading volume has been declining while the institutions' share has been rising.

5. Mutual funds have, by far, the highest portfolio turnover rates of all institutional investors. The latest data indicate that mutual funds as a group are turning over their assets at an annual rate of 35%. Some, including large funds, have a far higher turnover rate. Mutual funds also tend to engage in larger size transactions than other institutional investors and account for a large portion of secondary distributions and other types of block distributions of securities.

Our Report noted further that despite the fact that the assets of mutual funds have grown at a rapid rate in recent years, many of the large funds which have shared in this growth have reduced the number of different stocks in their portfolios. This concentration increases the power of a few fund managers to affect by their investment decisions the market in particular securities.

Further, as the irregular and relatively infrequent transactions of institutions in sizable blocks of securities become increasingly significant and the relative importance of individuals' 100- and 200- share orders declines, the auction markets find it increasingly difficult to maintain the high liquidity, depth and continuity which they traditionally have sought to achieve. Correspondingly, particular issues which mutual funds trade become more susceptible to sharp, sudden and erratic price fluctuations.

The growth of the funds and other institutions has resulted in substituting the investment decisions of a few professional managers regarding large blocks of securities for the decisions of large numbers of individual investors. Individuals' investment decisions tend to be heterogeneous since there are wide differences in their knowledge of pertinent information, ability to analyze the facts at hand, and in their personal motivations to buy or sell at any particular time. Their buy and sell orders at any one time tend to be in rough balance and their imbalances generally can be handled by the market activity of professionals -- specialists and others. Price fluctuations from order-to-order tend to be very close to the previous price.

Professional managers, however, tend to have the same pertinent information and similar ability to analyze it. Accordingly, their investment decisions tend to be homogeneous. A fund manager that is determined to sell a large block quickly may not be able to find institutional purchasers willing to buy the block at something close to the last price. If the block cannot be sold near that price to the public through a secondary distribution, the chances are that the stock's price will decline sharply. This in turn may cause other fund managers to dispose of or lighten their holdings of the stock, causing the stock's price to plummet downward. Here are some examples.

Case 1. On a single day in the Fall of 1966, well over 500,000 shares of the stock of one of the so-called glamour stocks were traded on the New York Stock Exchange. Trading in the issue opened at the high for the day and then skidded 16%, closing that day down 19 5/8 points. Now what did the funds have to do with that? Mutual funds bought 1,500 shares (about 1/4 of 1% of the day's trading) of that company during that day. But mutual funds sold nearly a quarter of a million shares (43.5% of the day's trading volume) on that day. Among these sales by the funds were one block of 25,000 shares sold at 115 1/4, another block of 32,000 shares sold at 114, and a third block of 137,000 shares sold at 109 1/2.

Case 2. In the Summer of 1966, another of the glamour stocks declined 8% or 17 1/2 points in two days. During that two-day decline, mutual funds sold over 130,000 shares of this company, approximately 44.7% of the two-day trading volume in the issue. True, some funds bought the stock as its price was skidding. But those fund purchases amounted in the aggregate to only about 50,000 shares, just about 37% of the massive volume of fund selling.

Case 3. During seven trading days in the Fall of 1966, another common stock declined 32 1/2 points from 151 1/2 to 119 so that the market value of the stock fell by more than 20% in little more than a week. During this decline aggregate mutual fund sales of about 70,000 shares accounted for 45.15% of the total trading volume. Mutual funds did some buying during this period. They bought 3,000 shares, just about 4% of the number of shares that they had sold.

While these examples are not commonplace, they are no longer unusual. More could be cited.

During the first two decades following the enactment of the Investment Company Act of 1940, investment by the funds for long-term appreciation of capital and income was the name of the game. In recent years, however, many relatively new funds have pursued investment policies which favor rapid turnover of portfolio securities in the light of short-term market movements. Some of these funds have been successful and a considerable number of their longer-established competitors -- but by no means all of them -- has placed increased emphasis on taking short-term profits and losses.

The reverse side of this short-term trading activity occurs when fund managers decide a stock is a good buy at or about its current price. So they begin to accumulate the stock. This does not mean they purposely act in concert; but as noted, their behavior patterns often tend to be homogeneous and show a striking degree of similarity. As some funds buy this stock -- and often the process of accumulation is slower than that of liquidation -- the price of the stock rises on heavy volume. Strong tape action may attract many individual investors and, when the funds stop buying and their purchases are disclosed and publicized, still other investors will buy, reasoning that fund managers' judgment is superior. By this time the fund managers may decide that the stock has no more potential for near-term appreciation and that other stocks are more promising. They sell. If other institutions agree that the stock is

overpriced, the funds may dump the stock or a substantial part of it. Now the stock's price may be down to where it was when the funds began to accumulate it. But many individuals will have bought the stock and have losses because of the short-term trading activities of the funds. The fund managers, moreover, may again repeat the process in the same stock or different stocks.

Whether or not such increased trading activity by the funds is properly labeled "speculative," the impact of their increased emphasis on short-term movements has had, as previously noted, and may increasingly have an unsettling impact on the continuity, liquidity and orderliness of the markets in particular stocks. Since some medium-size and a few large funds are engaging in this type of trading, and since they may hold a substantial portion of the floating supply of even the popular and widely held securities, the market impact of this type of trading can be even greater than that of the clearly speculative activities of a small number of unregistered hedge funds and of a few registered funds, whose assets are relatively small, whose disclosed investment methods emphasize speculation.

Hedge funds generally are partnerships of affluent persons which (i) claim an exemption from registration under Section 3(c)(1) of the Investment Company Act based upon the contention that they have no more than 100 securities holders and make no public offerings of their securities, and (ii) use speculative devices such as buying securities on margin, using put and call options, utilizing debt obligations, and short selling.

Numerous reports have been published in the news media of the concern of many in the securities industry, including leaders of its investment company sector, and of others about the impact of short-term trading and speculative activities by certain institutions and, particularly, by investment companies. Some, including the American Institute of Management and Chairman William McChesney Martin, Jr., of the Board of Governors of the Federal Reserve System, have compared such activities and the effects of such activities to the pool operations of the 1920s. Mr. Martin in a recent speech found "disquieting" the trend of certain mutual fund and other institutional managers to measure their success in terms of relatively short-term market performance. He stated:

"Given the large buying power of their institutions, there is an obvious risk that speculative in-and-out trading of this type may virtually corner the market in individual stocks. And in any event, activity of this kind tends to create undesirably volatile price fluctuations."

Mr. Martin concluded:

"The specific responsibilities of the securities industry to those who use its market place may be covered rather well by what used to be called the pursuit of long-run, enlightened self-interest. Customers . . . must not suffer as a result of inside trading or massive institutional speculation. . . It is the responsibility of the Exchanges and other market organizations to have proper rules and requirements and to see that these standards are scrupulously observed."

If I seem to have zeroed in on investment company managers, let me assure you that we are aware of quickened interest of other institutional managers in the profits to be realized from short-term trading.

The new wrinkle is that today's speculation and short-term trading is being done by professionals -- the managers of the so-called "Go-Go" funds and of other institutions. The manager of one of the newer "Go-Go" funds has explained this approach by stating that investment managers are much more technically oriented and that news moves faster. "What used to take two or three years to happen can now take place in a matter of months . . . [M]arket developments have become so tremendously compressed in time. . . The values are the same, but the realization of them is much more rapid. This is a much higher risk game than it was two years ago and there is a greater premium on being right." <sup>1/</sup> To me, this appears to mean that such professional managers are most concerned with trends, not basic values. And I, for one, find it difficult to distinguish this from speculation.

Many of you have been aware of the facts and the problems that I have just related. I am sure, therefore, that your question is what, if anything, has the S.E.C. been doing on this front?

The answer falls into two categories. First, to protect those who invest in mutual funds that engage in short-term trading, the Commission staff has reviewed fund prospectuses. The purpose of this review has been to assure ourselves that those who invest their savings in such funds will have adequate information toward the end that they will not unwittingly risk their money in speculative endeavors.

Secondly, toward the end of helping maintain the general investing public's confidence in the securities markets, we have initiated a fact-gathering program. We must know in greater detail than we now do of the nature, extent and impact of short-term trading activities by institutions.

We have sought and received the cooperation of the Investment Company Institute in obtaining on a monthly basis information showing a breakdown of most of their members' assets by type and the total value of portfolio securities purchased and sold by each member fund. We have proposed the adoption of a new reporting Form N-1Q for registered management investment companies which would make available on a calendar quarter basis information on the gross transactions of such companies in individual portfolio securities and on their securities holdings at the end of each quarter.

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<sup>1/</sup> A. Theodore Lyman, Jr., Senior Vice-President of Putnam Management Company, the adviser to Putnam Equities Fund, quoted in Financial World, September 27, 1967, p. 25.

Among other matters, we are studying the frequency, nature and impact of mutual funds' trading reversals, i.e., buying and selling or selling and then buying, in individual securities within 20 days. We also are studying the activities of the hedge funds to learn of the type and volatility of securities they trade and the relative short interest of hedge funds in those securities.

The studies made thus far demonstrate the complexity of questions presented by the growing role of institutions in the markets and by the increased emphasis some of them are placing on short-term trading. Our studies emphasize the need for still more detailed information in these and other areas if we are to obtain reliable answers to questions of market impact. There is a need for data which will provide, on a regular basis, a current and continuing picture of the participation of institutions in the markets.

This type of information is indispensable if we are to evaluate the adequacy of exchange markets and other markets for such trading, and if we are to be informed of the effects of such institutional market activity on non-institutional shareholders and on portfolio company managements. Without such knowledge, it will be difficult for us to know whether changes are necessary in exchange rules and in institutional disclosure requirements or whether legislation in this area is needed.

In addition to information from the exchanges, the Investment Company Institute and the Association of Closed-End Investment Companies, the Commission has been receiving some help in data gathering by institutions over which we do not have regulatory jurisdiction. Among these are the managers of 70 per cent of the total assets of non-insured pension funds, of 82 per cent of the total assets of life insurance companies, and of 60 per cent of the total assets of property and casualty insurance companies.

Analysis of the impact on the markets of institutional trading generally, and in particular short-term institutional trading, will require continuing and additional information from securities industry associations and institutional managers. I believe that these institutions will respond to Chairman William McChesney Martin's call for enlightened self-interest. I am hopeful that they will use their resources to supplement those of the Commission, and other governmental bodies that have an interest in these problems, in the compilation, analysis and evaluation of the information necessary to a better understanding of the impact of the changing nature of institutional trading activity in the securities markets.