REMARKS OF RICHARD B. SMITH, COMMISSIONER
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
AT COLLOQUIUM ON FINANCIAL MARKETS,
NATIONAL BUREAU OF ECONOMIC RESEARCH,
NEW YORK CITY, OCTOBER 22, 1970

Some Reflections on Economic Research and the Stock Market

The appearance of a lawyer--and at that one from a government agency often claimed to be too law-oriented--before a group of economists under the auspices of the NBER may be something of an exceptional event, totally apart from the persons involved. It is also heartening. Lawyers and economists can tend to be alien to each other, but tonight I am happy to say I am here by invitation, not on a visa.

Our professions have both had their detractors--yours has been called "a dismal science" and mine "a hocus-pocus science." Both of us I assume can live with the fact that our respective disciplines are exacting and yet not exact. But perhaps the most painful charge has always been that we are at times irrelevant. At one time or another the legal system, or a subpart of it, has been claimed to be either disregarding of the needs of those most in need of the protection of the law, or obstructive of the needs of economic efficiency, or both. Economics, at one time or another, has been accused of positing of focusing on such an abstract marketplace model that real, non-market factors and activities and objectives, important to most people, are disregarded. Perhaps a major basis for irrelevance claims against either lawyers or economists has been that we know or appreciate so little about the other's field.

These 50th anniversary colloquia of the National Bureau, and the recent report by John Meyer on research projects presently under way at the Bureau, show clearly its concern for relevance. A number of projects of the American Bar Association and other legal groups also demonstrate lawyers' general concern for making the parts of the legal system responsive. So there is some basis for being heartened. . .and a great deal remaining to be learned.

Today you have been exploring what is relevant research in the financial markets. I applaud that exploration because officials in government are remarkably dependent on the understanding of economic developments that grows out of research projects such as those sponsored or stimulated by the NBER. Substantial progress has been made during the last fifty years in an understanding of the forces at work in many, indeed most, of the nation's

capital markets. Studies by the NBER -- in capital formation and financing, in the processes of savings and intermediation, and in the measurement of national wealth through national income accounts, flows of funds and balance sheets -- have all contributed enormously to understanding of most of these markets, especially those for credit and debt, and the important institutional intermediaries operating in them.

I acknowledge the value and necessity of looking at all the financial markets and their interrelationships, but tonight I would like to narrow the focus to the stock market, to the different types of intermediaries that service that market, and to the individuals and institutions that participate in it. (These are of particular SEC interest, although I emphasize that the Commission does not purport to be an economic policy setting agency.) With some noteworthy exceptions, and at least until the very recent outpouring of econometric analysis, the stock market has been something of a stepchild all these years in terms of organized, systematic economic research.

In large part, I suppose, this state of affairs results from the generally low opinion most economists have held of the importance of the stock market in the economy. It is true that it is largely a secondary transfer market, as distinct from a primary issue market, and that underwriting firms associated with the stock market have been called on to produce in the post-war period relatively small amounts in new equity investment, when compared to the massive volume of direct and underwritten debt financing. It is also probably true that stock pricing is more affected by the vagaries of public psychology than is the pricing of other financial instruments. And most of the funds attracted into the stock market have, in the past at least, come from relatively limited upper-income and large wealth-holding groups. The argument is that the stock market is not a force itself but only reflects, sometimes sooner, sometimes later, the underlying real production, where policy-oriented economists must center their attention. I'll come back to these points later.

It is also likely, of course, that until the age of the computer the volume of stock market price data (and corporate financial data) was just too large and too expensive to manage for economic research. The well known stock indexes, valuable as they have been as the only available time series measurements, hardly seem adequate even to a layman for obtaining an understanding of the pricing functions, behavior and mechanisms of

the whole stock market, let alone the institutional structure of equity investing. There is an enormous expense involved in primary data collection in this area, characterized by so many inherently different security types, requiring data from so many sources, some of which have never been publicly available and most of which have not been conveniently available in machine usable form to private sector researchers.

The difficulty faced by potential research groups in this area may be illustrated by some of the experiences of the Commission's Institutional Investor Study, to which I shall refer later. The Study sent out 54 questionnaires, in some 200 separate versions, resulting in 800,000 card records. Repeated follow-up and editing chores required the services of a sizeable staff over a period of fifteen months. Up to 150 hours per week on various computer installations were needed just to edit and output very basic summaries on quantities of money invested by various types of institutions, types of accounts managed, types of securities held, portfolio turnover, trading characteristics, price impacts, risk, returns obtained, fees, expenses and promotional methods, patterns of concentration and affiliations across institutions, and other business relations with portfolio companies.

If I have some small quarrel with John Lintner's excellent and comprehensive paper discussed this afternoon, it is only his possible underestimation of the continued needs for primary data collection and compilation of existing uncollected data, at least with respect to the securities markets. It is my impression that even the flow of funds accounts are based on a number of assumptions and interpolations that deserve retesting. I suspect that the absence of assembled empirical data on the workings of the stock market and on many of the firms and institutions participating in it has discouraged research that otherwise would have taken place. I do hope that the Commission's Institutional Investor Study will make a marked step toward supplying some of these data. The economists conducting the Study tell me that it will. Donald Farrar, its director, is here tonight. And I hope it will serve as a springboard that will lead to supplying of relevant information on a more continuous basis in the future.

I would like to come back to the other, perhaps more basic reason for the relatively limited basic research efforts undertaken on the stock market--the assessment that it is not of primary concern in the economy. I had called it something of a

stepchild of economic research, but it is useful to note that it is quite a child in size. New York listed securities alone weighed in at 630 billion dollars at year-end 1969. By way of comparison, all Federal, state and local debt issues and long-term corporate bonds, combined, amounted to about 630 billion dollars at year-end 1969. The total market for corporate equities is larger by far than the market for any other type of publicly held or traded security. And of the 1.8 trillion dollars in total financial assets held by households in 1969, 40% were in corporate stocks. Yet a question remains. Does the child's sheer size matter? It does not reproduce itself via new issues constantly, as do securities having fixed maturities.

While I would not presume to attempt to give this particular audience any arguments on the subject that would be new to you, there are several things that perhaps can be said to indicate that this market still can matter importantly.

There are, for one thing, indications that stock market action has a strong effect on consumption. The proportion of household financial assets represented by corporate stock, to which I referred earlier, makes this understandable. Output from the FRB-MIT econometric model I am told tends to confirm it. You here who come from any of those private universities that decided in the last several years they should become "contemporary" in the management of their endowments--certainly you appreciate today how stock market levels can affect operating budgets!

For another thing, there are indications that stock market levels have marked effects on rates of business investment. There may be something of a chicken-or-egg question on that, but simply because the causative relationship is not clear, it warrants further study.

And then there is the liquidity of the stock market to consider. That has an effect on the cost of raising capital apart from the level of stock prices. While the degree of liquidity is related to price levels, it is also a function of the organization of the market, its structuring to efficiently bring potential buyers and sellers together and to provide adequate market-maker dealer participation. Discounts that exist on "restricted" equity securities (that is, stock that cannot be immediately sold in the secondary market) demonstrate that market liquidity has a value of its own. Those discounts amount to 20% or more from otherwise identical "registered" securities of the same company that are actively traded in the secondary market.

Having said that, I should add that the concepts of market depth and liquidity are not simple and deserve a great deal more study themselves. There are some, of course, who have argued that it is only oppressive SEC disclosure requirements that produce the discount. Those disclosure requirements, however, have contributed both to more accurate pricing, within the tolerances of supply and demand, and to the investor confidence that has contributed to public participation in those markets.

While I do not think that it has ever been empirically demonstrated, there seems to me to be an essential relationship between the liquidity and depth of the secondary trading markets and the willingness of American investors not to demand higher dividend payouts and instead to allow corporate management to retain and reinvest earnings of the enterprise. The capital gains tax, I believe, accounts for only part of this investor willingness. An equally strong factor is the confidence that American investors have that they will be reasonably well informed about what management is doing with the retained earnings, and that when they may wish to convert their stock holdings into money for whatever reason, they will be able to do so promptly and at a price representative at that time of the corporation's value (including the use of retained earnings).

Thus, strong secondary markets, buttressed by disclosure requirements, seem integral to a system that permits the massive reinvestment of corporate earnings. In 1969 earnings retained by corporations amounted to $24 billion, compared to a gross of $9 billion received in cash from sale of new equity issues, and net new equity issues (after retirements, repurchases, etc.) of $4 billion. The average annual figures for the preceding ten year period 1959-68 were $20 billion retained earnings, $4 billion gross new issues, and $1 billion net new issues.

There are other ways in which equity markets and their pricing matter. They can, and have, stimulated corporate mergers or takeovers and affected the terms on which they are consummated. I shall not attempt to pursue that line of inquiry this evening -- except to note that by affecting the investors and the managers who control American business, a secondary market can have an enormous influence on the growth, development and character of the American economy.

Strangely enough the emergence of large institutional investors in the stock market, particularly the mutual funds and the pension funds, represents a great increase in public involvement in that market. The mutual and pension funds, and, while still relatively small in terms of equity investment, the potentially large insurance companies and public retirement funds, hold savings of millions of medium and low income families. And as the level of affluence has spread in the country, the number of individual direct investors has substantially increased in the post-war period. So no longer, if it ever could have been, can the stock market be considered simply a sport for the rich. Large stock price fluctuations mean something real and important to many people.

Some have felt that there is too much psychology involved in the stock market to warrant serious economic attention. If one accepts the important functions of the stock market, it seems to me that the presently indefinable impact of public psychology is a reason for further study and attention rather than less. I liked John Meyer's report presented to the Board of Directors of the Bureau at its spring meeting that I interpreted to express this approach in a broader context. It is nevertheless pertinent here. He said:

> "Concern with negative externalities, moreover, may lead us into some entirely new departures and research interests. We may be led to substantially rework our entire theory of consumer behavior, for example, to reflect new information and concepts on the allocation of time, or on the role of expectations in conditioning savings behavior under different regimes of price stability or instability. Perhaps, too, this new theory of consumer behavior might be more psychological and behavioral and less normative than the conventional theory."

Individual investors are an important element in the liquidity of the market. Because of that and in view of the fact, according to the national flow of fund accounts, they own about 70% of all corporate equities (a somewhat lesser proportion of publicly traded stocks), it would be a fruitful area of research to get a better understanding of the activities of individual investors. How long do they hold stocks on balance? What are their investment returns? What proportion of them account for individual trading volume? What motivates most their allocation of savings and what are the time lags?

Further, systematic study of stock market organization and of the financial structure of securities firms is also warranted. The pending Securities Investors Protection Corporation bill in Congress, the pending commission rate structure proceedings, and the periodic broker-dealer financial statements that are now being submitted to the NASD will be providing a new reason and basis of aggregate information for such study. It is an industry undergoing relatively rapid transformation, from partnership to corporate form, from largely proprietary management to management separate from ownership, from manual paper operations to automated systems, to mention just a few. Better decisions by the industry itself and by government regulators would result from such economic research.

I would not want to close without expressing appreciation for the assistance and important contribution that the National Bureau and Ray Goldsmith have given to the Commission's Institutional Investor Study. Because the Study report is still in the writing and will not be sent to the Congress until the end of the year, it would be premature for me to discuss its findings tonight.

What we asked the Bureau to do under the project direction of Dr. Goldsmith was to provide some aggregate background and time perspective by which to judge the importance of the stock market and the institutional participants in it. Existing statistics on saving investment and financing over long time series were supplemented by new and hopefully improved estimates of the value of corporate securities outstanding. New estimates of the assets of foundations and colleges, and of those managed by banks as personal trusts and estates were made. The availability of these estimates permits the household residual in the national flow of fund accounts to be somewhat more clearly a measure of the financial activities of individuals than was previously the case. Some attempt was made at disaggregating the corporate nonfinancial business sector by industrial group in order to observe differences in financing patterns. A new series was also developed on the replacement value of tangible assets, so that the relative sizes of the real and of the paper economy can be better assessed. The Study thought this background helpful to its new empirical work on current institutional investment.

I have strong personal hope that this first relationship on research between the Bureau and the Commission will not be the last, but instead will be the forerunner of systematic research and collaboration in research in the years to come.

Thank you.