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# HAVE WE LEARNED ANYTHING?

Remarks by

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Commissioner

Securities and Exchange Commission

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First, I would like to express my very deep gratitude for the opportunity to attend your meeting and address you today. This organization is and, it and its predessor has been for 34 years the authentic, articulate and effective spokesman of one of the most important elements of the securities industry. It has been alert in advancing the interests of its members and has at the same time advanced the interests of those who have chosen investment companies as a means of saving and investment. It has been, as I have personally witnessed as a Commission member, a rich source of information, insights, analysis and advice with regard to regulatory matters. There is little need to make explicit what all of you know, namely, that on numerous occasions the judgments of this organization and those of the Commission are not in step. However, and may we all be thankful for this, the system that has developed over the years, provides ample opportunity for all viewpoints to be expressed and I can

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say based upon my own experience that these expressions of opinion frequently modify actions which the Commission proposes to take.

We are hopefully moving out of one of the most vexing periods the securities and investment business has ever known. Barron's, this week, tells of the improved lot of your funds and your industry; the President, his advisers, many influential Congressmen and Senators and a fair number of businessmen are convinced we are at or near the bottom of our present economic miseries. But before we move into a time of prosperity, I think we should reflect on what we have gone through, what brought us there, and what must be done in the future to make our system work better than it did in the past.

A concatenation of historic events has had all of us, regulators and regulated alike, trying valiantly to cope with problems we had never experienced before, problems we did not foresee, problems which challenged every bit of imagination, skill and intelligence we have.

Partially as a consequence of our Vietnam commitment and partially due to explosive consumer demand, we embarked on a period of huge economic expansion. The government decided to finance our $150 billion Vietnam expenditures without imposing upon the American people the sacrifices which had been demanded in previous conflicts. Out of this came unprecedented inflation.

In an effort to control this we experimented with wage and price controls, for the first time in peace time. Distortions of our balance of payments resulted in unique restraints on American foreign investments and ultimately we experienced two devaluations of the dollar. In addition to that businessmen during this time developed new and exciting configurations. Having determined upon diversification to minimize the risks of having all of a company's eggs in the same basket, they went beyond this and found the concept of "synergism" which afforded the excuse for a degree of diversification perhaps not seen since the 20's, if then.

All of these circumstances impacted significantly the conduct of investors, individual and institutional alike. Fired by inflationary pressures, easy money, and the confidence induced by a booming economy, American investors dived into the equity markets as if they had never heard of 1929 - and indeed many had little or no memory of that last orgy. The Dow Jones industrial average pushed through the magic 1,000 mark after several false starts; the number of 1933 Act registrations filed at the Commission rose to a high of 4,314 in 1970, of which 2,071 represented companies making their first filing under that Act. As stock prices rose the most common caution was, "buy equities as a hedge against inflation."

Conventional investing habits seemed inadequate for this fast-moving economic world. Investment companies had through most of their history been regarded as essentially conservative means of investment; even the ones which invested exclusively in equities were so regarded. The first indication that mutual funds might be for responding to the new euphoric environment was the increasing emphasis on "growth funds" which brought into investment company portfolios a larger element of risk and appealed to those who were less concerned with present cash yield and who were willing to take the additional risks that traditionally accompanied opportunity for greater capital growth. Analysts and investment advisers, responding to the speed with which the economy changed and the fortunes of individual enterprises fluctuated, concluded that management of investment portfolios demanded a good deal more activity than had been common in the past and "performance" became the magic word. "Go-Go" no longer referred to girls in bars and began finding its way into the financial vocabulary. In 1964 the activity rate of investment companies was 18.2% per annum. By 1967 this had increased to 40.7% and by 1969 to 51%.

The portfolios of more conservatively management investment companies, as well as those of other institutional investors,

became dominated by a relatively small group of stocks, the top tier of the so-called two-tier market. These soared to astonishing heights, and this simply whetted appetites even more. During that wonderful time all of us assumed, sophisticate and amateur alike, that somehow or other it would go on forever, despite the lessons that we should have learned from the past.

Abruptly the great post-World War II bull market came to an end and the dire prophecies of those who had been bears for years suddenly seemed germane and relevant and, worst of all, apparently right. Suddenly the game became not one of calculating excitedly the extent to which portfolios had outperformed the Dow Jones or the S. & P., but rather one of worriedly determining the extent to which their declines were less than the declines recorded by those popular indices.

Not unpredictably all kinds of questions began to be asked about the underlying premises of our investment system. As many institutional investors reported losses that went beyond those that would have been experienced had one been able simply to invest in the Dow Jones Industrial or the Standard and Poor averages, or the market in general for that matter, many people wondered whether there was any value at all in this vast and complex system of security analysis that had been developed over

the years; they wondered whether it might not be a sham and a delusion, masking the essential irrationality of the markets. A belief gained currency that one could do as well in selecting securities by throwing darts at a copy of The Wall Street Journal listing of New York Stock Exchange securities. As a matter of fact the editors of one of the foremost financial publications of the country did that and recorded after a year or so that in the aggregate their results had not been significantly different from those accomplished by many who selected securities through more rational means. Interestingly enough the single biggest winner using that method was the editor and publisher of the magazine, a man of considerable wealth, whose dartboard portfolio outperformed that of the other editors by a significant margin. That phenomenon gave even greater credence to the oft-heard maxim that indeed the rich do get richer, no matter what.

All of this has led many to conclude that indeed the market is irrational, that it is useless to try to find any analytical means of performing better than the market and that over a period of time there's no way to achieve legally superior performance.

These critics assert that all the elaborate research paraphernalia that we have built, all the skills that security analysts purportedly have, all of the investment advisory services that are published, are useless and that inexorably the market goes forward, up and down, in its own mysterious way.

And yet there lingers in the back of our minds the knowledge that there are funds, banks and investors that have persistently over the years outperformed the market and outperformed most of their competition. We read in Supermoney about the exploits of Warren Buffet and reject the notion that he is simply the beneficiary of extraordinary good fortune. We read about other investors who have over the years read the signs with greater perceptiveness and have profited with fair consistency.

More than that, I think perhaps the wrong comparisons have been made.

I would suggest that a comparison of professionally managed portfolios with the portfolios of individuals who made their own investment decisions with little or no professional assistance would be far more shocking. While undoubtedly many institutional portfolios were loaded with "high flyers" that came down if anything more rapidly than they went up, I do not think you found in very many of those portfolios the sort of new issues that were greedily grabbed by individuals who were mesmerized by promoters and unscrupulous dealers. Furthermore the institutional portfolios did not

invest in some of the tax shelters which appeared appealing because of the tax benefits they afforded, but which, when analyzed in terms of the benefit to the investor, in many instances look even worse than the performance of more conventional investments.

Notwithstanding assertions that the planned portfolio performs no better than the unplanned, randomly, even accidentally, selected portfolio, I think there is a good case to be made for the conviction that security analysis, careful selection, and intelligent appraisal have a positive rather than a neutral or, as sometimes suggested, even negative effect. The alternative is one that I simply will not accept. I will not accept that professional education as an analyst, intelligent application of trained intelligence to the plethora of information that is available about American issuers, the highly ethical endeavor to reach honest judgments on bases other than inside information is all for naught. We have over the years built in this country an enviable investment process. This process has resulted in markets that are honest, open, well-regulated, well-designed to afford maximum protection to anyone involved in the process. Our system produces an abundance of information, the accuracy of which is assured, with few exceptions, by the stringent application of law with significant adverse consequences following from departures from the standards. We have developed through our

educational institutions and through special programs designed by professional societies and others a sizable corps of well-qualified, well-educated, well-equipped and increasingly experienced experts in financial analysis. (Parenthetically I should add however, that while most advisers perform well and honorably, I think in many respects our regulation of this important function in the investment process is inadequate and I would strongly urge that the Commission and the Congress direct their attention, now that it appears the major securities legislative endeavor which has occupied their attention for four years is near completion, to the necessity of tighter regulation of the competence, the ethics and the integrity of this profession.) We have provided multiple opportunities for individual investors to avail themselves of the professional skills and services that are available. No one in this country now need feel, no matter how small his portfolio, that he is unable to secure the benefits of using these professionals. Your funds, banks and advisers and advisory services are readily available to him.

If what I have said concerning the value of education, experience and skill is true, then it seems to me evident that the average investor trying to manage his own portfolio without professional assistance is at a distinct disadvantage.

Individuals simply are not equipped to make the complex judgments that are required by modern securities markets, to determine intelligently the proper makeup of a portfolio suited to his individual circumstances, to assimilate the vast amount of information that pours out from innumerable sources, to assess the relationship of individual securities to national and international economic changes. In short the average individual, despite all that we may do to make information available and understandable, when investing, competes with any who have time, the techniques and the skills to utilize effectively the vast resources for financial analysis which we have made available in our system.

As investors analyze the shambles remaining after the recent market debacle; after they realize that many of their investments have lost value irretreivably; after they recognize that, poor as the performance of many institutionally managed portfolios may have been, at least they have retained a superior capacity for recovery, which is now becoming evident, then I think many will realize that there is indeed merit in the professional management of money.

Your industry and money management professionals in general can hasten and strengthen this realization if you want to. How? It is essential to focus the public's attention on the fact that the investment process is essentially a long term one, although obviously as a person's judgments change, as the economy changes, as the fortunes of an individual company change, portfolio changes are sensible. But it must be emphasized that rarely is the stockmarket or an investment company a magic road to riches. The speculative fever that characterized the late 20's and the late 60's and early 70's must be recognized for what it was: a modern version of the tulip bulb mania. Unfortunately even very sophisticated people can be affected by this mania and caught up by the belief that the stock market, unlike anything else in the world, is a one-way street to bounty. Investment in equity securities, either directly or through the medium of investment companies or managed accounts, must be recognized for what it is -- a means of prudent accumulation and not a means of vastly exceeding the long-term movement of the market in general.

Secondly, the professionals must reflect objectively and somewhat humbly on what went wrong. To what temptations did they yield when they should not have? When did courage fail them in resisting fad and what captured the imagination at the moment? They must be quicker to recognize corporate financial and accounting

practices that yield excessive and misleading expectations, for instance, the accounting for combinations, franchise fees and land development sales, and they must shun industries and companies that engage in fantasy accounting. In short, there is no substitute for prudence and caution and care in investing.

Thirdly, of course there must be the most careful avoidance of anything that smacks of duplicity, self-dealing, conflicts of interest, and indifference to fiduciary duties. With fixed commissions now relegated to the history books, new temptations will be cast before the eyes of institutional managers and traders. Already we are being asked questions about what can properly be deemed research for which business may be allocated or commissions paid. If abuses appear it may be necessary for the Commission to speak to this issue and lay down guidelines. But frankly I don't think a consciencious, scrupulous professional needs us to tell him that a subscription to The Wall Street Journal or Fortune, or legal or accounting services, or office furniture is not the "research" which he can lawfully buy with his beneficiary's dollars.

One further thought. It seems to me that investment companies must be responsive to the emergence of basic problems in our economy and must assess the extent to which they have a role in resolving or alleviating them.

We hear a good deal these days about the dangers of federal financing "crowding out" corporate financing. I would suggest that there is another type of "crowding out" that may be equally important and that is the "crowding out" of the opportunity for financing by small enterprise by the financing activities of large ones. I recently attended a conference at which the representatives of very large businesses and banks as well as of the government discussed the problem of financing. It was apparent that if a capital shortage occurs in this country, the first claim on available capital resources will be that of large, well-capitalized, stable, solid, long-established enterprises. It was apparent that their historic relationships with the sources of capital, the safety which an investment in them enjoys, and the relative absence of hazards and uncertainties will afford them a preferred position. If this is so, where and how in any period of capital shortage will the needs of small businesses, or even fairly good sized businesses, be satisfied?

Any shortage of capital will hit disproportionately the smaller, less attractive companies. And yet all of us recognize that a stifling of these enterprises because of the shortage of capital would ill serve the public good. We often sing loud with the praises of the small enterprise, the traditional entrepreneur, and we recognize that through his ingenuity and enterprise, enormous benefits have been bestowed upon the entire nation. The examples are legion to justify this conviction; most of our corporate giants were at one time poorly capitalized, struggling projections of a single man's vision and imagination. Something would be irreparably lost to this country if our smaller businesses could not secure money with which to expand and develop. The tendencies towards "bigness" which worry many, including many of conservative economic bent, would be accelerated and expanded.

Frequently it is suggested that the manner in which this problem should be dealt with is by governmental extensions of credit or governmental guarantees of financial assistance to small businesses or through governmental allocation of credit to assure that these enterprises have greater access to capital markets. Alluring as these means may be, and as necessary as such measures may sometimes be, nonetheless I would suggest that

all of these fall far short of solving the basic problem and moreover they are less compatible with our accustomed and previously quite successful ways of doing business in this country. It is far better if all businesses of this country, large and small, have their capital needs satisfied through the operations of a free credit market and only when distortions in the operation of those free markets seriously adversely affect the long-term interests of the nation should the mechanism be tampered with.

The ability of small enterprises to secure equity capital is of course in large measure dependent upon the state of the secondary markets for the outstanding securities of those companies. In the not distant past we heard a great deal about the two-tier market and extreme concern was expressed over the tendency of institutions to invest in a relatively narrow band of securities. I am fearful that recent developments may further intensify this tendency and result in even greater difficulty for small enterprises in securing recognition of their value. The Pension Reform Act with its standards of fiduciary responsibility, and the right, frightening to many fiduciaries, of any beneficiary to sue those responsible for investments may very well induce many

fiduciaries to adopt very conservative investment policies and favor only the securities of the largest and best capitalized corporations. This would in my estimation be an unfortunate consequence to the nation of an otherwise worthy piece of legislation.

I think it is important that institutions, including investment companies, pay greater attention to the securities of these so-called second-tier companies. In saying this I am not advocating that fiduciaries take unwarranted "flyers" and jeopardize the integrity of the assets that they manage. Rather I would suggest that, burdensome and onerous as it might sometimes be, it would be well if institutional investors allocated larger portions of their research and analysis dollars to these securities. It is frequently said that it is simply not economic to analyze in depth a company with a relatively small float of stock. There may be some truth in that, but I would suggest that there are other considerations which should justify the expenditures that would be necessary to do that. First, I think there are ample opportunities for sound investment and substantial gain among smaller companies. The evidence of institutional interest in the outstanding securities of such companies is often the key which can unlock the market for new capital and enhance the soundness of the investment. Second,

while I recognize that the prime obligation of a money manager is the welfare of those whose funds he is managing, nonetheless I do not think he can be indifferent to the overall quality of the economy of the country. His horizon should be wider than simply tomorrow's stock quotations and he should recognize that the interests of his beneficiaries are long term. I think that he can be sensitive to these considerations without surrendering or diluting the fruits of skillful money management; it is simply a matter of reordering the priorities for research and analysis.

With the increasing institutionalization of the markets, it is apparent that unless the institutions invest in smaller companies, inevitably those issuers are going to suffer increasing difficulties in finding a place in our complex and well-populated capital markets. Senator Bentsen has proposed that a small part of pension trust portfolios be exempted from the prudent man rule in an effort to encourage greater risk-taking on the part of those fiduciaries. I am not sure that this is the sort of approach that should be taken, but if the fear of liability and the concern over the utilization of scarce resources to analyze smaller enterprises proves to be too much for managers, then it may well be

that some governmental intervention to remove such fears and concerns may be necessary. I would think that any pool of money which enjoys a special tax benefit might well be called upon to earn that preferred position by having among its concerns the development and preservation of a climate within which small enterprises can successfully tap the capital markets. Thus I would think it not inappropraite, if volunatary action proves insufficient, for the government to provide that pension funds which may accumulate income tax free; charitable endowments and foundations which enjoy similar privilege; and investment companies which are permitted to avoid taxation at the corporate level, in some small manner contribute to spreading out the capital resources in this nation.

I'm not enthusiastic about such proposals. On the other hand I am not enthusiastic about the consequences of closing the door to capital for many worthy enterprises in this country.

As we begin the long haul back from the trough into which we have slipped, we all share, I think, a chastened spirit, a humbled pride, and a new sensitivity to the perils inherent in our endeavors. These should arm us against a recurrence of that past and lead to a more solid and enduring success in the delicate and awesome art of managing other people's money.