

MONEY

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Chapter 1

Too Much Cost, Not Enough Value

Let me begin with this wonderful old epigram from nineteenth-century Great Britain:

Some men wrest a living from nature and with their hands; this is called work.

Some men wrest a living from those who wrest a living from nature and with their hands; this is called trade.

Some men wrest a living from those who wrest a living from those who wrest a living from nature and with their hands; this is called finance.

Even today, these strong words continue to describe the realities of the relationship between the financial system in which I've spent my entire career and the economy at large.

The rules under which our system works—which I call, after Justice Louis Brandeis, “The Relentless Rules of Humble Arithmetic”—are ironclad:

- The gross return generated in the financial markets, minus the costs of the financial system, equals the net return actually delivered to investors.
- Thus, as long as our financial system delivers to our investors in the aggregate whatever returns our stock and bond markets are generous enough to deliver, but only *after* the costs of financial intermediation are deducted (i.e., forever), the ability of our citizens to accumulate savings for retirement will continue to be seriously undermined by the enormous costs of the system itself.
- The more the financial system takes, the less the investor makes.
- The investor feeds at the bottom of what is today the tremendously costly food chain of investing.

The essential truth, then, that sums up each of these inarguable points: On balance, the financial system subtracts value from our society.

Those are the modern realities of our financial system, but they have been building for a long time, just as the financial sector itself has been building for many decades into the largest single element of the American economy.

We have moved to a world where far too many of us seemingly no longer make anything; we're merely trading pieces of paper, swapping stocks and bonds back and forth with one another, and paying our financial croupiers a veritable fortune. In the process, we have inevitably added even more costs by creating ever more complex financial derivatives in which huge and unfathomable risks have been built into the financial system.

Warren Buffett's wise partner Charlie Munger lays it on the line:

Most money-making activity contains profoundly antisocial effects. . . . As high-cost modalities become ever more popular . . . the activity exacerbates the current harmful trend in which ever more of the nation's ethical young brain-power is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others.

I share Mr. Munger's concern about the flood of young talent into a field that inevitably subtracts so much value from society. When I speak to college students, I often say exactly that. But I never advise them directly not to go into the field of managing money. Words alone aren't going to discourage anyone from entering a field so highly profitable. Rather, I ask young graduates to

consider three caveats before doing so. And I would ask you, whatever your calling, to consider these same caveats and how they might apply to your own life and your own understanding of how, in our own transitory lives, we go beyond what is “enough” in the search for satisfaction and happiness, and strive to do much more than enough good for our fellow human beings.

A Prophetic Forecast

At the very peak of the boom in the financial sector, in a commencement speech at Georgetown University in May 2007, here’s what I had to say on this subject:

- One, if you enter the financial field, do so with your eyes wide open, recognizing that any endeavor that extracts value from its clients may, in times more troubled than these, find that it has been hoist by its own petard. It is said on Wall Street, correctly, that “money has no conscience,” but don’t allow that truism to let you ignore your own conscience, nor to alter your own conduct and character.
- Two, when you begin to invest so that you will have enough for your own retirement many decades hence, do so in a way that minimizes the extraction by the financial community of the returns generated by business. This is,

yes, a sort of self-serving recommendation to invest in low-cost U.S. and global stock market index funds (the Vanguard model), but doing so is the only way to guarantee your fair share of whatever returns our financial markets are generous enough to provide.

- Three, no matter what career you choose, do your best to hold high its traditional professional values, now swiftly eroding, in which serving the client is always the highest priority. And don't ignore the greater good of your community, your nation, and your world. As William Penn pointed out, "We pass through this world but once, so do now any good you can do, and show now any kindness you can show, for we shall not pass this way again."

As it turns out, the warning I set forth in that speech—the need to recognize “that any endeavor that extracts value from its clients may, in times more troubled than these, find that it has been hoist by its own petard”—proved not only eerily prophetic, but surprisingly timely. The industry has been blown up by its own dynamite.

Sure enough, in July 2007, just two months after my speech, the financial sector—led, as it were, by Citigroup and investment banks Merrill Lynch and Bear Stearns—began to crumble, as the risky, reckless, complex, and costly debt instruments that its firms created

began to come home to roost. Enormous write-downs in balance sheet valuations followed. By mid-2008, those write-downs in the aggregate totaled an astonishing \$975 billion, with more to come.

Wresting a Living from Finance

In my speech at Georgetown, I noted that during 2006 the financial sector alone accounted for \$215 billion of the \$711 billion in earnings of the 500 companies that make up the S&P 500 Stock Index—30 percent of the total (and perhaps 35 percent, or more, if we included the earnings of the financial affiliates of large industrial companies, such as General Electric). The domination of financial companies in our economy and our stock market has been extraordinary. The earnings of these financial firms *alone* totaled more than the earnings of our highly profitable energy and technology companies *combined*, and about *three times* the earnings both of our booming health care sector and of our giant industrial firms.

By the time 2007 had ended, financial sector earnings had plummeted by almost half, to \$123 billion for the year. Not only had financial sector earnings shrunk from 30 percent to 17 percent of the \$600 billion earnings total

of the S&P 500 companies; the sector also accounted for fully 90 percent of the S&P 500 decline in earnings for the year. The carnage has continued during 2008. Call it poetic justice.

But is it? The clients of the banking firms have lost hundreds of billions of dollars in the risky debt obligations that the banks created, and layoffs of employees are rife—more than 200,000 financial sector workers have already lost their jobs—yet most investment banking executives continue to be paid at astonishingly high levels.

I'm reminded of a story, perhaps apocryphal, I recently read about an investment banker addressing his colleagues after the collapse in the mortgage-backed bond market. "I have bad news and good news. The bad news is that we lost a ton of money. The good news is that none of it was ours." This story provides yet one more reminder that, for the most part, what is good for the financial industry is bad for you.*

*It is at least possible that not all financial firms put their own interests ahead of the interests of their clients. When John Thain, a former top executive at Goldman Sachs, became the CEO of Merrill Lynch in late 2007, he was asked how the firms differed. His answer: "Merrill does truly put clients first." You'll have to decide for yourself about the validity of the claim.

Fortunes from Failure

Consider the compensation of three well-publicized financial sector CEOs who failed their clients and their shareholders alike during the recent turbulence.

- Charles Prince, CEO of Citigroup, took office in October 2003, with Citigroup stock selling at \$47 per share. While the bank did well for a few more years, it created a highly risky investment portfolio that fell to pieces within five years, with write-offs (so far) of some \$21 billion. Citigroup's earnings fell from \$4.25 in 2006 to \$0.72 per share for 2007, and the stock, at this writing, is at about \$20 per share. Mr. Prince was paid \$138 million for his efforts when times were good, but incurred no penalty for the disaster that followed. (Prince resigned on November 4, 2007.)
- The experience of Stanley O'Neal, CEO of Merrill Lynch, was similar. The risks assumed by the firm in its risk-laden investment portfolio exploded late in 2007, with \$19 billion of write-downs (with likely more to come). Merrill reported net losses for the year of \$10.73 per share, and its stock price tumbled from \$95 per share to less than \$20 currently. Yet Mr. O'Neal's compensation of \$161 million during 2002–2007 was

not affected, and the retirement plan package that he received on his resignation in October 2007 was paid in full by the board (*another* \$160 million, for a total of \$321 million).

- Perhaps most egregiously, James E. Cayne, CEO of Bear Stearns, was paid some \$232 million during 1993–2006 as the stock price of this investment banking powerhouse rose from \$12 per share to \$165. But the firm’s risky and largely illiquid investment portfolio, along with its high leverage (assets of about 35 times capital), brought Bear to the edge of bankruptcy. The Federal Reserve was required to guarantee the value of much of the portfolio before JPMorgan Chase agreed to buy the company for a price of \$2 per share (ultimately raised to \$10)—measured from the high, a loss of some \$25 billion of shareholder capital. But Mr. Cayne’s millions of dollars of compensation had already been paid. (While his investment in Bear, once valued at \$1 billion, had dropped to \$60 million when he sold his shares in March 2008, probably most of us believe that \$60 million is an awful lot of money, especially given the catastrophic loss of capital by other shareholders and the devastating loss of jobs by thousands of Bear employees who played no role in the firm’s demise.)

To paraphrase Winston Churchill, “Never has so much been paid to so many for so little” in the way of accomplishment.

Heads I Win; Tails You Lose

As rich as our financial kings have become over the past few decades—and as much unjustified cost as they have extracted from investors—their wealth pales in comparison with the wealth accumulated by our most successful hedge fund managers. In 2007 alone, the 50 highest-paid hedge fund managers together earned \$29 billion (yes, *billion*). If you didn’t make \$360 million in that single year, you didn’t even crack the top 25. Yes, for high-stakes gamblers, speculation—whether in Wall Street, at the race track, or in Las Vegas—can produce huge speculative rewards.

According to the *New York Times*, the highest-paid hedge fund manager for 2007 was John Paulson, who took down a cool \$3.7 billion. It is said that his firm, Paulson & Company, made more than \$20 billion for his clients by betting against certain mortgage-backed securities (more fully described later). Who’s to begrudge Mr. Paulson a large share of the rewards that his firm

earned for its clients by such a remarkably successful speculation?*

Not I! My problem with the incredible compensation earned by hedge fund managers is its asymmetry—its lack of fundamental equity. Managers on the winning side of speculation win big; but the losers don't lose big. For example, if the Paulson firm indeed *won* its gamble by betting that mortgage-backed securities or collateralized debt obligations would tumble (or being on the right side of the rank speculations known as credit default swaps), some other firm *lost* its gamble, betting that those debt obligations (or those swaps) would rise. The other side, it follows, would have *lost* \$20 billion. But those managers, as far as anyone knows, didn't give \$20 billion back to their clients. So the huge cost of our financial system rose, benefiting insiders even as their clients were impoverished (relatively speaking).

*I do begrudge hedge fund managers the maximum 15 percent tax rate that the federal government applies to so-called carried interest, an obfuscatory phrase referring to the share of profits paid to hedge fund managers. Such a low rate is an insult to those hardworking citizens whose far smaller earned incomes are often subject to standard federal tax rates that are twice as high or more. I also understand that clever tax planning enables this income to be deferred, free of any taxes and earning a return until drawn down later. Unsurprisingly, attempts at tax reform by Congress have been overwhelmed by the well-funded lobbyists hired by hedge fund managers.

A hypothetical example makes this point clear. Suppose you invested in a fund of hedge funds, with two managers running equal shares, one on each side of the trade described earlier. One earned 30 percent and one lost 30 percent, so your account was even . . . so far. But you paid the winner, say, 20 percent of his 30 percent gain—or 6 percent—plus his 2 percent management fee, a total of 8 percent. You also paid the loser his base fee of 2 percent, bringing the fee on your entire account to an average of 5 percent. Then you paid the fund-of-funds manager another 2 percent. So, even though your portfolio had an investment return of zero (before costs), you lost 7 percent of your capital. Once again, industry wins; investor loses.

Brain Drain

Inevitably, the enormous incomes received by hedge fund managers in the recent era and the staggering salaries and bonuses paid to investment bankers have enflamed the imaginations of many of the nation's graduates of our business schools and made Wall Street the preferred destination for their careers. Despite the alarm sounded by the likes of Charlie Munger and others, the flood of young brainpower into the financial sector continued to pick up momentum even as the financial markets lost theirs. The number of Chartered Financial Analysts (CFAs) has

reached a record high of 82,000, and *Barron's* recently reported that “no fewer than 140,000 new applicants—also a record high—from every corner of the earth are queued up to take the exams that will confer on the lucky ones the coveted [CFA] imprimatur.”

Perhaps I should be cheered by such news. This is, after all, a calling to which I have devoted my entire career. I fear, though, that the motivation of too many of those rushing into finance is more aligned with what they can get from society than what they can give back to it; and it is a mathematical certainty that the cost of the services provided by their firms, as a group, will exceed the value that they create. That is the issue on which I want you to focus: *the disconnect between cost and value in our financial system.*

The Drain of Costs and Taxes

Let's start with the costs, where it is easiest to see through the haze. Over the past 50 years, the (nominal) *gross* return on stocks has averaged 11 percent per year, so \$1,000 invested in stocks at the outset would today have a value of \$184,600. Not bad, right? But it costs money for individuals to own stocks—brokerage commissions, management fees, sales loads, advisory fees, the costs of all that advertising, lawyers' fees, and so on. A good estimate of

these costs is at least 2 percent per year. When we take out those assumed investment expenses, even at the rate of only 2 percent, the historic rate of *net* return would drop to 9 percent, and the final value would drop by more than one-half—to just \$74,400.

If we assume that as little as 1.5 percent is paid by taxable investors to cover income taxes and capital gain taxes on that return, the after-tax rate of return would fall to 7.5 percent, and the final wealth accumulation would plummet by *another* one-half, to \$37,000. Clearly, the wonderful magic of compounding *returns* has been overwhelmed by the powerful tyranny of compounding *costs*. *Some 80 percent of what we might have expected to earn has vanished into thin air.* (Caveat: In terms of *real* dollars, reduced by the 4.1 percent inflation rate over the past half-century, the final inflation-adjusted value of the initial \$1,000 investment after costs and taxes would be—instead of \$184,600 in nominal, precost, pretax dollars—a minuscule \$5,300!)

The Wrong Kind of Wizardry

The costs of our financial system today are so high largely because we have abandoned the traditional (and successful) standards of investing, well described by the words of the legendary Benjamin Graham, as they appeared in the *Financial Analysts Journal* of May–June 1963:

It is my basic thesis—for the future as for the past—that an intelligent and well-trained financial analyst can do a useful job as portfolio adviser for many different kinds of people, and thus amply justify his existence. Also I claim he can do this by adhering to relatively simple principles of sound investment; e.g., a proper balance between bonds and stocks; proper diversification; selection of a representative list; discouragement of speculative operations not suited for the client's financial position or temperament—and for this he does not need to be a wizard in picking winners from the stock list or in foretelling market movements.

Anyone familiar with the ideas I've advocated during my long career would not be surprised to know that I passionately subscribe to these simple principles of balance, diversification, and focus on the long term—to say nothing of being skeptical that stock pickers and market-forecasting wizards can, on balance and over time, add value.

In fact, when I entered the mutual fund industry 57 long years ago, its money managers invested pretty much in the manner prescribed by Graham. Then, the portfolios of the major equity funds consisted largely of diversified lists of blue-chip stocks, and their portfolio managers invested for

the long term. They eschewed speculation, operated their funds at costs that were (by today's standards) tiny, and delivered marketlike returns to their investors. However, as their long-term records clearly show, those fund managers were hardly "wizard[s] in picking winners."

Costs Rear Their Ugly Head

Today, if fund managers can claim to be wizards at anything, it is in extracting money from investors. In 2007, the direct costs of the mutual fund system (largely management fees and operating and marketing expenses) totaled more than \$100 billion. In addition, funds are also paying tens of billions of dollars in transaction fees to brokerage firms and investment bankers and, indirectly, to their lawyers and all those other facilitators. Fund investors are also paying another estimated \$10 billion of fees each year to financial advisers.

But in their defense, mutual funds represent just one part—actually a relatively *small* part—of the total costs that investors incur in our nation's system of financial intermediation. Add to that \$100 billion in mutual fund costs a mere \$380 billion in additional investment banking and brokerage costs, plus all those fees paid to the managers of hedge funds and pension funds, to bank trust departments and financial advisers and for legal and accounting fees, and the tab comes to roughly \$620 billion

annually. (No one knows the exact number. All that can be said for certain is that, one way or another, these billions are paid by the investors themselves.)

And don't forget that these costs recur year after year. If the present level holds—I'm guessing that it will grow—aggregate intermediation costs would come to a staggering \$6 trillion for the next decade. Now think about these cumulative costs relative to the \$15 trillion value of the U.S. stock market and the \$30 trillion value of our bond market.

Investors Get Precisely What They *Don't* Pay For

The fact that investor returns lag market returns by the costs of the system is unarguable, yet it is often also argued that our financial system adds value to our society because of the other benefits it brings to investors. But such a claim belies the reality of our system, in that it does not operate under classical free market conditions. The system is fraught with information asymmetry (which favors sellers over buyers), imperfect competition, and irrational choices driven by emotions rather than reason.

This is not to say that our financial system creates only costs. It does create substantial value for our society. It facilitates the optimal allocation of capital among a variety of users; it enables buyers and sellers to meet

efficiently; it provides remarkable liquidity; it enhances the ability of investors to capitalize on the discounted value of future cash flows, and other investors to acquire the right to those cash flows; it creates financial instruments (often including so-called derivatives, often of mind-boggling complexity, whose values are derived from still other financial instruments) that enable investors to assume additional risks, or to divest themselves of a variety of risks by transferring those risks to others.

No, it is not that the system fails to create benefits. The question is whether, on the whole, the costs of obtaining those benefits have reached a level that overwhelms those benefits. The answer, alas, seems obvious enough, at least to me: The financial industry is not only the largest sector of our economy; it is also the only industry in which customers don't come anywhere near getting what they pay for. Indeed, given those relentless rules of humble arithmetic, investors in the aggregate get precisely what they don't pay for. (Paradoxically, then, if they paid nothing, they would get everything!)

A Question So Important

Over the past two centuries, our nation has moved from being an agricultural economy, to a manufacturing economy, to a service economy, and now to a predominantly financial economy. But our financial economy, by

definition, deducts from the value created by our productive businesses. Think about it: While the owners of business enjoy the dividend yields and earnings growth that our capitalistic system creates, those who play in the financial markets capture those investment gains only *after* the costs of financial intermediation are deducted. Thus, while investing in American business is a *winner's game*, beating the stock market before those costs is a *zero-sum game*. But after intermediation costs are deducted, beating the market—for all of us as a group—becomes a *loser's game*.

Yet despite the vast and, until very recently, rapidly growing dominance of the financial sector in our total economic life, I know of not one academic study that has systematically attempted to calculate the value extracted by our financial system from the returns earned by investors. Nor had a single article (except my own) on the subject ever appeared in the professional journals, neither the *Journal of Finance*, nor the *Journal of Financial Economics*, nor the *Journal of Portfolio Management*, nor the *Financial Analysts Journal*. The first article of which I am aware—Kenneth R. French's "The Cost of Active Investing" (in U.S. stocks)—is, in mid-2008, pending publication in the *Journal of Finance*.

That veil of ignorance must be lifted. We need to find ways to radically improve our nation's system of capital formation, through some combination of education, disclosure, regulation, and structural and legal reform.

If this book is a goad toward that goal, my writing it will have been time well spent. But the point is that the job must get done. Until it is, the financial economy will continue to subtract inordinately from the value created by our productive businesses, and in the challenging times that I see ahead, that is a loss we can no longer tolerate.

In June 2007, Princeton University valedictorian and economics major Glen Weyl (now Dr. Weyl, having earned his PhD in economics only a year later) described his passion for intellectual inquiry in this way: “There are questions so important that it is, or should be, hard to think about anything else.” *There are questions so important that it is, or should be, hard to think about anything else.* The efficient functioning of our nation’s flawed system of financial intermediation is just such a question.

It’s high time not only to think about this question, but to study it in depth, to calculate its costs, and to relate those costs to the values that investors not only expect to earn, but are entitled to earn. Our financial system carries quite enough cost—in fact, far too much cost—and therefore (again, by definition) doesn’t create nearly enough value for market participants. Finance indeed wrests its living from those who wrest their livings from nature, from commerce, and from trade. It is essential that we demand that the financial sector function far more effectively in the public interest and in the interest of investors than it does today.