

{Thought in Action} books



JERRY DAVIS says Americans bought into too many myths about the financial markets.

Portfolio Society

Gerald Davis' New Book Traces Risks of Fixation on Financial Markets

The recent crash in the credit and financial markets has hit average Americans hard. The fallout is far-reaching, from rising unemployment and an economic slowdown to a stock market that consumed whole retirement plans. Meanwhile, the burst housing bubble went beyond lowering property values. Extracting equity from a home's rising value was commonplace, and now many homeowners are upside down on their mortgages. In his new book, *Managed by the Markets*, **Gerald Davis**, the Wilbur K. Pierpont Collegiate Professor of Management, argues that Americans settled on corporations providing the social welfare safety net — healthcare and pensions — in the 20th century. That model became untenable with the takeover wave in the 1980s, the break-up of conglomerates, and greater corporate dependence on the financial markets. A culture of high finance permeated society as Americans expected these markets to offer security in the form of 401(k)s and mutual funds. But something seemed to get lost along the way: Risk was always part of the equation.

DIVIDEND: One of the central ideas in your book is that finance became almost a secular religion after the 1980s because the financial markets, after the takeover boom, re-shaped corporate behavior. These are the corporations that had provided healthcare and pensions but couldn't keep doing so because of shareholder pressure. How do we know it wasn't the other way around: that corporations sought this change through their desire for diversified sources of liquidity?

DAVIS: If you look back in American history to 1980, the diversified conglomerate was the prototypical U.S. corporation. During the 1980s, because of innovations in finance and deregulation, many manufacturing conglomerates were taken over — about one-third of the Fortune 500 disappeared between 1980 and 1990, mostly against the wishes of their executives. These companies were typically bought and split back up into their component parts, which were often sold to related buyers. We ended up with a reshuffled industrial landscape and a very different mindset among businesspeople. In 1980, few CEOs would say, "This corporation exists to create shareholder value." In 1990, almost all of them did. And so you saw a cultural shift among managers and in what we taught in business school: Companies should be focused, and shareholder value was king. That was the purpose of the corporation. This is very different from how corporations had been conceived prior to that point. When he was building his company, David Packard was famous for stating, "Hewlett-Packard does not exist to make a profit, it exists to make a contribution." There were many stakeholders whose needs had to be balanced. Packard's view largely disappeared, partly because of the takeover wave and the ascendance of the shareholder value idea, and also due to the practice of paying executives extravagant amounts of stock options, which closely tied their economic well-being to increasing the company's stock price.

DIVIDEND: But if companies didn't exist to create shareholder value, why did they exist?

DAVIS: It's a question of whether shareholders are one among many constituencies or the primary constituent. Before the 1980s, the view was that shareholders were entitled to a certain reasonable return. Not a maximum return, a reasonable return.

DIVIDEND: But it was more than that. You point to a convergence of events that changed the role of finance in society.

DAVIS: One that everybody is feeling these days is the advent of the 401(k) plan in 1982. At that time, only about six percent of American households owned mutual funds, which were mostly the domain of the well-off. Because companies found they could use 401(k) plans to cede the responsibility of managing an employee's retirement assets, they moved employees to defined contribution plans and phased out company pensions. As a result, many more people ended up owning stock through their 401(k) plans. That had a pretty big effect. Once people had gotten a taste of 401(k) programs, they came to think of themselves more as investors. They became more comfortable putting their savings into retail mutual funds. By the turn of this century, more than half of American households had money invested in the stock market. Another event was the takeover boom, which I already discussed. A third event was the growth of mortgage securitization — that is, bundling mortgages together and turning them into financial instruments, which had the effect of sensitizing people to market movements to a degree they would not have been otherwise. Since most mortgages get re-sold as bonds, it made them more accessible, both to first-time buyers and to refiners. Half of the people with mortgages in the U.S. refinanced them in the first four years of this decade. That helped grow an industry of mortgage brokers, whose job is to either find people to buy new homes or to refinance existing homes. Because of the prevalence and accessibility of refinancing, many people came to think of their home as a financial vehicle, or a savings vehicle, and it further sensitized them to changes in the financial markets.

DIVIDEND: What were some of the problems associated with that?

DAVIS: There were some myths accepted as fact. One is this notion that houses always go up in value. That perception is detached from what the empirical evidence shows. If you look from 1890 to 1997, home values in the U.S. essentially stayed flat. They basically kept pace with inflation, on average, for about a century, and I would argue that the securitization of mortgages had the unintended effect of fueling the crazy ascent of prices over the previous decade.

Another myth is that stocks are a fool-proof retail investment, nearly as safe as a savings account. In the 1990s, how could you not believe that stocks always go up over time, with the constant drumbeat of the financial media? But for any given 10-year period, it's not clear what might happen. Certainly, looking at the last 10 years, you would have been much better off putting your money into a CD than putting it into the S&P 500. It doesn't mean that stocks won't go up over the next 50 years or the next 100 years. But when people start to treat mutual funds like a savings account that always increases in value, those people are likely to get burned.

DIVIDEND: But isn't broader participation in the financial markets, overall, a good thing?

DAVIS: In principle, the theory behind participation in financial markets is that it will have an educating effect on people: They will come to understand net present value and care about what the Fed does. In practice, it isn't true. People don't necessarily have the time or inclination to become sophisticated about investment. In fact, what it tends to do is attune them to things like TV personalities saying crazy and inappropriate things. What people are more likely to remember is that the market always goes up over the long term and that somebody on TV says this or that stock is good or bad. Now we're seeing the negative consequences of people becoming overly tied to financial markets, both in terms of their economic security and in terms of the lessons they draw from finance.

DIVIDEND: You're saying that this societal tie to the financial markets delayed our transition to the post-industrial era. So how do we get there? Is government always the answer?

DAVIS: One way to think about it is to consider the array of problems we want society to solve for us. We want to consume safe foods and medicines. We want to have money for retirement. We want our kids to attend good schools. So there are a lot of things we want society to do for us, and there's always going to be a mix of market-based, individually initiated solutions and government-based solutions. It's fair to say the corporate sector did a pretty darn good job for most of the 20th century in addressing some of these issues, but it can't solve them anymore. ✦ —Terry Kosdrosky

