Futures Shock

Are Greedy Brokers Ruining The Economy?

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IN A RECENT PUBLIC RELATIONS DOCument, The New York Stock Exchange defines its mission statement as to: "Support the capital-raising and asset management process by providing the highest quality and most cost-effective, self-regulated marketplace for the trading of financial instruments." The common thread that runs through this and similar statements made by organized financial markets from Frankfurt to Tokyo is that they hold as their primary goals to help companies raise capital and to provide a liquid and efficient aftermarket for those securities.

Fulfillment of these objectives has brought the combined market value of the U.S. equity markets to in excess of $3.5 trillion, and the future health and prosperity of our financial system rests on its continuing success. But recent activity in U.S. financial markets has had little to do with building on this country's future economic base.

As a result, the number of initial public offerings on the AMEX has fallen in the past three years, with only 18 companies filing in 1989. The IPO market was the birthplace of almost all our publicly traded companies and added billions of dollars and thousands of jobs to the economy. Its degeneration will be sorely felt in the years to come. As critical as this is to the future of our economy, there has been little or no recognition of the basic problems the market now faces. Rather than striving to rejuvenate the supply of new equity capital, and with apparent disregard for their primary mission, the emphasis in the financial markets over the last several years has been mainly the developing and trading of derivative securities.

Such financial instruments as index futures on the NYSE Composite, the S&P 500 and the Major Market Index (MMI), options on those futures, and futures in such sectors as technology and oil have become the major force behind the market's movements. These index futures and options are derivative or "synthetic" securities, whose price is based on an average of a group of stocks. In order to rationalize its actions, the financial community has cultivated the belief that investment in these securities allows investors to "participate" in the performance of the underlying stocks, while helping the market to be more liquid and efficient in pricing, and this without negative effects on the market as a whole. But the idea, though popular with Wall Street professionals, in fact oversimplifies a complex and potentially dangerous problem.

The Allure

The main attraction of index futures is that they provide much more leverage–due to both their pricing structure and lower required margins–than do investments in an equity portfolio. This means that investors can control larger investments and enjoy much higher potential returns, albeit at a higher risk, than those available with common stocks.

But their apparent connection with the stock market belies the fact that index futures are nothing more than legalized numbers games wherein the "number" happens to be the averaged value of a group of stocks, as opposed to the number of attendees at the track on a given day or the number chosen in a lottery drawing.

Unlike stocks, futures and options have set termination dates, so investment in index futures represents a gamble that the group of stocks will move up or down in price by enough to cover your bet before the future contract expires. If by that date your gamble fails to materialize, you may follow the time-honored tradition of horse race bettors–rip up your tickets and go back to the betting window to try again.

In any case, putting money into index futures may have a payoff, but it is no more an investment than going to the track or spending the weekend at the tables in Las Vegas. Index futures are gambles, and the people putting their money into them should realize they are gamblers, not investors. This difference is not rhetorical. Gambling is largely a zero-sum game–someone wins, someone loses and the house (brokerage house) always takes a cut. Investing is not a sum-sum game–investment creates value. Your gain is not at the expense of someone else's loss.

In all fairness, derivative securities do not have gambling as their espoused goal. Index futures and options, like all options, can be used as mechanisms for hedging or "selling" risk. If we look at the history of commodity futures and options we find that they were "invented" to help producers of commodities (farmers) eliminate the price risk of their crops and to simultaneously help consumers (bakers, etc.) lock in the cost of those commodities. So both producers and consumers eliminate their price/cost risk and improve their ability to plan and budget. At least in the commodity markets, then, futures and options can serve a valuable economic purpose.

The Risk Factor

Conceptually, the process of using index futures and options for hedging risk in the stock market is similar to that of the commodities market. Known as portfolio insurance, the mechanism enables investors who own a stock portfolio or a sector mutual fund to hedge away their investment risk by selling index futures or buying put options on an index future. In this light, these derivatives help investors find acceptable levels of risk for their stock portfolios and in so doing may increase the number of potential investors in the stock market.

But the idea of selling risk in the equity market does not necessarily legitimize index futures. Investors who want investments that are less risky than common stocks can always invest in the corporate and government bond markets–that's what they're for.

Furthermore, though they're both

assets, stocks and commodities have very different risk structures. Hedging in the commodities market protects investors from price exposure over a specified period where that exposure is created by the production or consumption of a business inventory. In contrast, equity investors face perpetual price exposure that is only mitigated by index futures when the possibility exists they will need to liquidate in the immediate future. As such, investments in index futures make investors more liquid, but only at the expense of viewing equity as a permanent investment.

What of the Long Term?

Therein lies the rub. The permanence of equity is critical, and risking one's own capital investing in a corporation's future is what equity is all about. This basic tenet, ownership in equity, has worked quite successfully and has helped promote the market's growth for well over 100 years.

In addition, the defense of index futures as a hedge does not explain why the market should legitimize gambling by supplying a regulated market for "naked" positions. A naked position occurs when the index future or option is not accompanied by an investment in a portfolio of the underlying securities and the investor is simply betting on the value of the underlying index for profit. Information on the total dollars devoted to investment in naked positions is not readily available, but a cursory examination of investment trading patterns indicates that a substantial proportion of the multibillion-dollar index future industry is not covered by investment in the underlying stocks.

As such, these naked positions represent a form of "risk capital" investment that few normal equity investments can compete against. Since there are only so many dollars to go around, each "risk capital" dollar devoted to a naked position may be one dollar taken away from the IPO or risky end of the equity market.

In the minds of investors, each product or type of security in the market competes with every other security based on return per unit of perceived risk. But the fact of the matter is that less and less investors are choosing to invest in risky new issues, while the perceived risk/return ratio is so much more appealing in the index futures and options market. As a result, growth spawned by new publicly generated capital, like IPO's, is starting to falter. The impact of this in the future may be a stagnant and competitively deteriorating economy. Without question, the relative growth of new capital in such foreign markets as Japan, Singapore and Malaysia has far outpaced that of the U.S. in recent years. Perhaps it is no coincidence that these stock markets also have little or no index future and option activity.

Has there been any introspection within the financial markets regarding the drift away from their mission? In short, the answer is no. The decision by the administrators of the NYSE and AMEX to create, and the executives of the major brokerage houses to market, these derivatives over the past 10 years has been driven by one factor alone, and it probably has little to do with making the markets more efficient. The more likely reason that our financial agents have erred from acting in accordance with the fulfillment of the market's mission is much more banal.

Simply put, they have replaced the formal mission of the financial markets with their own personal objective of wealth maximization. The reason why the spotlight only now falls on this issue is that, historically, this has not been a problem. Until recently, the financial agents' personal objective of wealth maximization has been reasonably fulfilled by his following the market's mission.

As evidence, we find the market's explosive growth over the past 20 years, taking a once staid profession and turning it into the thing dreams of "yuppiedom" are made of. Sustaining the business end of the financial market as a growth industry required creativity and entrepreneurship.

Going for the Gold

On August 7, 1980 the New York Futures Exchange (NYFE) opened and on April 29, 1983 stock index options began trading on the AMEX. The essential idea was to move in and out of common stock positions to take advantage of minute and momentary pricing differences between the indexes and their underlying stocks. Interestingly enough, almost no one questioned what the impact of treating tangible units of corporate ownership as nothing more than components in an arcane mathematical formula would be.

The financial services industry had found a gold mine. They could package an "index" and sell it to investors, who could take advantage of the appreciation available throughout the whole market without owning a single stock. In addition, since the margins required by the S.E.C. were much lower on futures than on stocks, investors could control much more money in the market, effecting trades more often and larger than they might in the stock market. (It just so happens that, as a matter of law, most Wall Street professionals are compensated based on the amount of trading they complete with clients.) All of this trading activity produced many a millionaire on Wall Street. Of course, in the end this led–arguably not through a causal line–to the 1987 stock market crash.

For the past few years, the resulting drought on Wall Street has found numerous victims. Unemployed investment bankers aside, and with the exception of the most solid "blue chip" stocks, the rest of the market and especially the IPO and newer issues market have never recovered. Member-firm commissions have declined from their 1988 peak and are not expected to grow substantially any time soon. This has left investment houses searching for things to do, but instead of bearing down and trying to resuscitate a market in cardiac arrest, most have chosen to replicate the mistakes of their past.

By choosing to pursue "synthetic" securities and the gambler's mentality imbedded within them instead of concentrating on promoting equity and the investor's mentality of ownership, our financial agents are influencing the basic foundations of the economy. The idea of investing in a company's future, evaluating its product line, marketing and distribution strategy, and determining that its intrinsic value is higher than its current stock price is almost an extinct art form.

So international equity markets, their regulators and their investors should look closely at the U.S. experience and learn. Their time may be running out, as derivative products are expanding into other international equity markets, including Japan, Canada, England and Brazil.

It is no coincidence that the explosion of these "synthetics" accompanied the stock market crash and that they continue to promote the doldrums found in equities markets today. The investor's psyche should not be reduced to that of a gambler's, nor should the concept of ownership in a company's future be relegated to the status of "old-fashioned" thinking and replaced with the idea of instant liquidity and index arbitrage. The effects of these attitudes are far-reaching and they may not be reversible.

As for emerging international markets, they would be well-advised not to use the current U.S. approach to investing as a role model. If their objective is to serve as a conduit for companies looking to raise capital, then being "old-fashioned" is probably the better way. ●

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