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BusinessWeek

THE DEATH OF EQUITIES

How inflation is destroying the stock market

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THE DEATH OF

How inflation is destroying

On July 23 institutions that manage pension fund money began operating under a new and far more liberal interpretation from the Labor Dept. of what is a prudent investment under the Employee Retirement Income Security Act of 1974 (ERISA). Pension fund money can now go not only into listed stocks and high-grade bonds but also into shares of small companies, real estate, commodity futures, and even into gold and diamonds. "The decision throws the door wide open to hard assets for institutional investors," says a jubilant Jack B. Backer, a New York diamond dealer.

To millions of people, that ruling could mean a higher return on their pension fund assets after years in which inflation has nibbled away at the return from more traditional investments. On another level, the Labor Dept. ruling is just one more in a nearly endless string of unhealthy things that have happened to the stock market over the past decade.

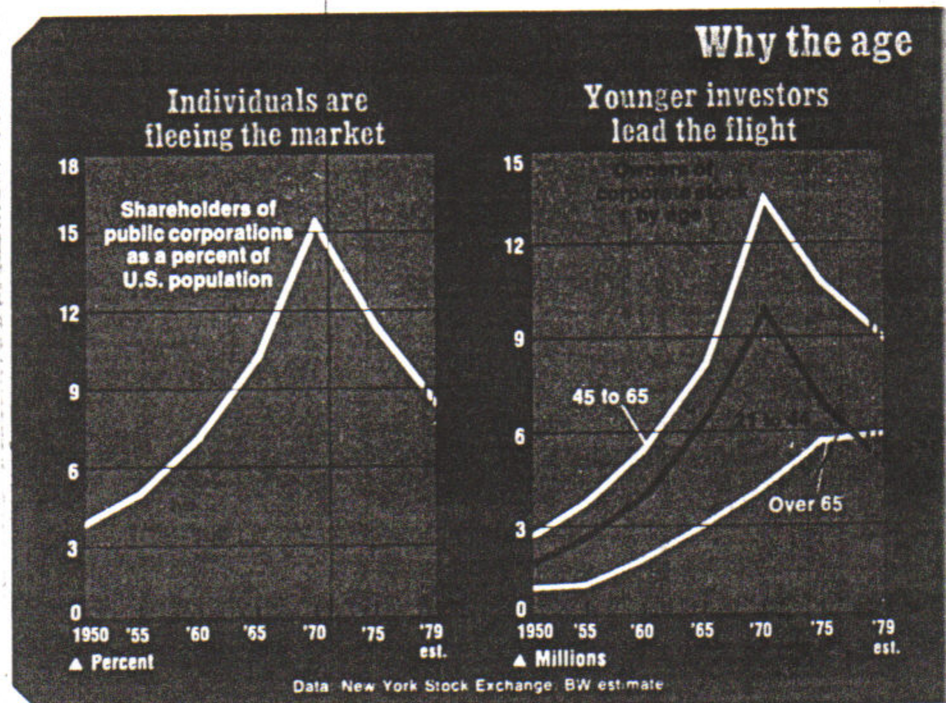
Only the elderly remain

At least 7 million shareholders have defected from the stock market since 1970, leaving equities more than ever the province of giant institutional investors. And now the institutions have been given the go-ahead to shift more of their money from stocks—and bonds—into other investments. If the institutions, who control the bulk of the nation's wealth, now withdraw billions from both the stock and bond markets, the implications for the U. S. economy could not be worse. Says Robert S. Salomon Jr., a general partner in Salomon Bros.: "We are running the risk of immobilizing a substantial portion of the world's wealth in someone's stamp collection."

Until now, the flight of institutional money from the financial markets has been merely a trickle. But it could turn into a torrent if this year's 60% increase in oil prices touches off a deep recession while pushing inflation sky-high. As it is, the nation's financial markets and its capital flows have been grossly distorted by 13 years of inflation. Before inflation took hold in the late 1960s, the total return on stocks had averaged 9% a year for more than 40 years, while AAA bonds—infinitely safer—rarely paid more than 4%. Today the situation has reversed, with bonds yielding up to 11% and stocks averaging a return of less than 3% throughout the decade.

As a result, even institutions that have so far remained in the financial markets are pouring money into short-term investments and such "alternate equity" investments as mortgage-backed paper, foreign securities, venture capital, leases, guaranteed insurance contracts, indexed bonds, stock options, and futures. At the same time, individuals who are not gobbling up hard assets are flocking into money market funds to nail down high rates, or into municipal bonds to escape heavy taxes on inflated incomes. Few corporations can find buyers for their stocks, forcing them to add debt to a point where balance sheets seem permanently out of whack. On Wall Street, the flight from stocks has forced firms to push alternative investments hard—thereby drawing still more money from the stock market.

Further, this "death of equity" can no longer be seen as something a stock market rally—however strong—will check. It has persisted for more than 10 years through market rallies, business cycles, recession, recoveries, and booms. The public was first drawn to equities in big numbers in the 1950s by a massive promotion campaign by Wall Street that worked because the economic climate was right: fairly steady growth with little inflation. To bring equities back to life now, secular inflation would have to be wrung out of the economy, and then accounting policies would have to be made more realistic and tax laws rewritten. But these steps may not be enough. "It will take two or three years of confidence building, of testing, before the market can seriously act like it did in the 1950s and early '60s," says William J. Fellner, a professor of economics at Yale University and a member of President Nixon's Council of Economic Advisers.



The problem is not merely that there are 7 million fewer shareholders than there were in 1970. Younger investors, in particular, are avoiding stocks. Between 1970 and 1975, the number of investors declined in every age group but one: individuals 65 and older. While the number of investors under 65 dropped by about 25%, the number of investors over 65 jumped by more than 30%. Only the

EQUITIES

the stock market

elderly who have not understood the changes in the nation's financial markets, or who are unable to adjust to them, are sticking with stocks.

Even if the economic climate could be made right again for equity investment, it would take another massive promotional campaign to bring people back into the market. Yet the range of investment opportunities is so much wider now than in the 1950s that it is unlikely that the experience of two decades ago, when the number of equity investors increased by 250% in 15 years, could be repeated. Nor is it likely that Wall Street would ever again launch such a promotional campaign. The end of fixed stock market commissions has thinned the ranks of firms that sell stocks (page 58) and reduced the profit from selling stocks for virtually all firms. Wall Street has learned that there are more profitable things besides stocks to sell, among them options, futures, and real estate, that it did not have in the 1950s. For better or for worse, then, the U. S. economy probably has to regard the death of equities as a near-permanent condition—reversible some day, but not soon.

Says Alan B. Coleman, dean of Southern Methodist University's business school: "We have entered a new financial age. The old rules no longer apply."

The one rule whose demise did the stock market in could be summed up thus: By buying stocks, investors could beat inflation. Stocks were a reasonable hedge when inflation was low. But they proved helpless against the awesome inflation of the past decade. "People no longer think of stocks as an inflation hedge, and based on experience, that's a reasonable conclusion for them to have reached," says Richard Cohn, an associate professor of finance at the University of Illinois. Indeed, since 1968, according to a study by Salomon of Salomon Bros., stocks have appreciated by a disappointing compound annual rate of 3.1%, while the consumer price index has surged by 6.5%. By contrast, gold grew by an incredible 19.4%, diamonds by 11.8%, and single-family housing by 9.6%.

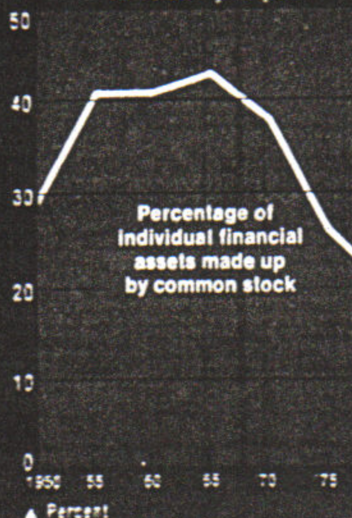
At least 20 banks now include hard assets in their pension accounts. First State Bank of Oregon, which has allowed customers to put gold and silver into retirement accounts since 1974, is now letting them add diamonds. "We're going to see more and more investment in diamonds, gold bars, Krugerrands, and silver coins," predicts Vice-President Richard W. Rhodes.

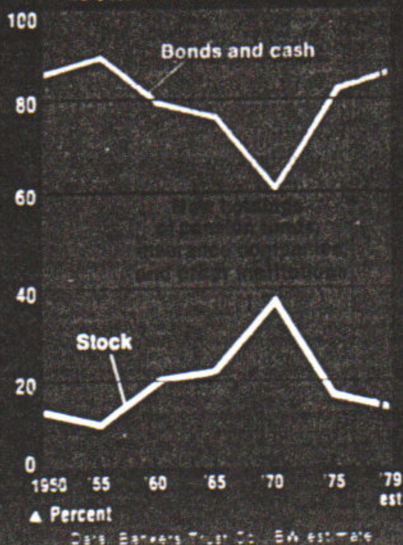
Just last May, for example, First-Citizens Bank & Trust Co., in Greenville, S. C., began accepting diamonds in its self-directed trust accounts because of increasing demand from its customers. "At least 95% of these customers are trying to escape what inflation is doing to stocks," declares Vice-President Ronald O. Holland.

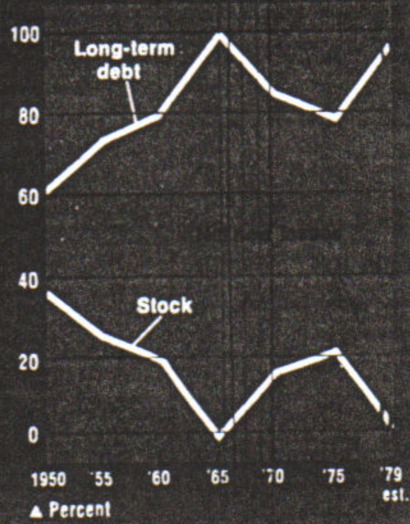
There are at least four good reasons why inflation is killing equities:

- Stock prices reflect anticipated corporate profits. During periods of rapid inflation, however, profits fall because most businesses cannot raise prices quickly enough to keep up with costs.
- Even gains in profits are largely illusory because inflation makes them look rosier than they actually are. And because plant and equipment are depreciated at historic cost rather than replacement price, money that should go into capital, investing and inventory

of equities may be over







Data: Bankers Trust Co., BW estimate

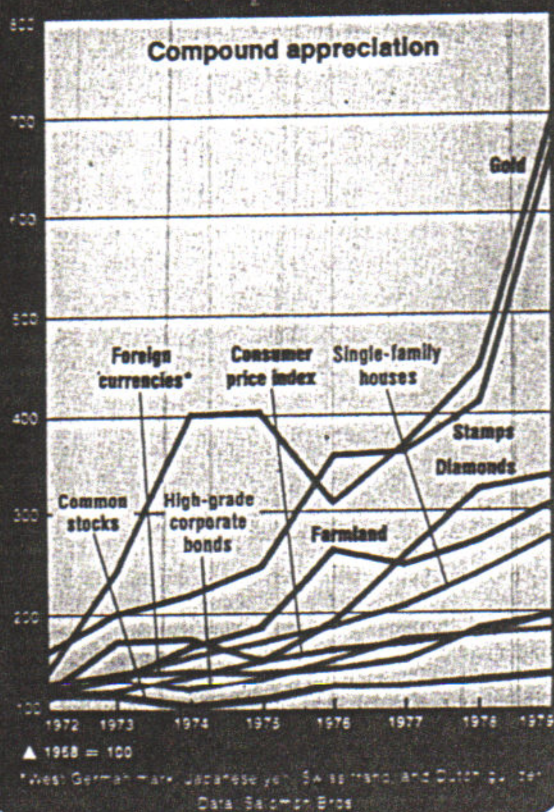
Jerry Tortorella—BW

purchasing instead goes to the government in taxes.

- Experience has taught investors that inflation will lead to an economic downturn that will wreck corporate profitability and stock prices. This happened in 1974, when the worst recession since the Depression followed the last burst of double-digit inflation.
- Investors jump from stocks to bonds to nail down high rates. Inflation also prompts corporations to sell debt because it is tax-deductible and can be paid off in cheaper dollars—thereby reducing the flow of new stocks to market.

Further, inflation makes investors very cautious. "We are coming down with the European disease," says Thomas A. Martin, president of American Asset Management Co., pension managers with $127 million in assets. Indeed, European institutions have been putting up to 40% of their money into hard

Steve Hart/BW



*West German mark, Japanese yen, Swiss franc, and Dutch guilder
Data: Salomon Bros.

assets—especially real estate—for years. In 1974, for example, the British Rail Superannuation Pension Fund sank $58 million into fine arts, ranging from Picasso's *Young Man in Blue* to 12th century candlesticks. Since then, the fund has been putting 4% of all new money into art, on the grounds that such diversification would give it maximum protection from inflation.

U. S. institutional investors are now following suit. The Minneapolis Teachers Retirement Fund Assn., for one, has bought fast-food stores such as Pizza Hut, Burger King, Kentucky Fried Chicken, and Wendy's, which it leases to franchisees. The program has been so successful that the fund, which puts 10% of its portfolio into such deals, may boost its commitment to 33%. "Our assumption is that we should make at least the rate of inflation plus 5%," says Newell O. Gaasedelen, executive secretary of the fund. "These investments have helped us reach that goal."

Gaasedelen adds that his strategy is far safer than it might appear, pointing out that most of the franchises are backed by guarantees from large fast-food corporations. In addition, the value of the land involved is generally half the total package, and with ever-escalating real estate prices, the land is a hedge against loss.

Concern about the safety of investments outside the financial markets is the main reason institutions have been so leery of them until now. Under the original prudent man ruling written by Massachusetts Judge Samuel Putnam 150 years ago, many institutions felt themselves barred from putting money into anything except stocks and bonds. But even before the Labor Dept.'s decision, the rule was being made more irrelevant with every discouraging government economic report. "Given the type of consistent high-level inflation we've been experiencing, the stock market represents speculation, and some tangible assets represent the opposite," says Edward R. McMillan, chief economist for Seattle's Rainier National Bank.

Today, one of the strongest proponents of gold investing is Alaska Governor Jay Hammond. He plans to resubmit a bill to the legislature early next year to lift a law, passed in the early 1960s, that prevents the state's public employee and teachers retirement funds from investing in gold, foreign securities, or real estate. At least three other states are also interested in tangibles for their retirement funds. "The statute was fine for the 1960s, but unfortunately we're not living under those same economic conditions," says Alaska's deputy treasury commissioner, Peter Bushre. "We're living under double-digit inflation, huge balance-of-trade deficits, and a serious energy problem. The current action of both the bond market and equity market bear me out."

Indeed, since the U. S. government's $35-per-oz. ceiling on the price of gold was lifted in 1971, the metal has soared by more than 700% to above $300 per oz. The Dow Jones industrial average set its all-time high of 1051 in 1973, but since then it has sunk nearly 20% to its current 830. And if the Dow is adjusted for inflation, as it should be, the results are truly horrendous, an approximate loss of 50% in purchasing power.

Just about the only group not discouraged by such figures are U. S. corporations. Although generally unable to sell stocks themselves, companies have jumped on low stock prices to set off the biggest takeover binge in history. "The merger boom is essentially an attempt to invest in hard assets," points out one investment banker, adding: "A buy rather than build decision makes excellent sense, since buying at these prices is cheaper than building." Indeed, in the past few weeks alone, Mannesmann of West Germany has announced plans to take over Harnischfeger for $245 million, Britain's Midland Bank to acquire Walter E. Heller International for $531 million, and McGraw-Edison to buy Studebaker-Worthington for a staggering $723.5 million. The potentially biggest merger yet is Exxon Corp.'s $1.2 billion tender offer for control of Reliance Electric Co., now being challenged by Washington.

Eccentric money markets

Other corporations are following a slightly different strategy: buying up their own shares. "The market is understating the real value of assets, and this does not encourage companies to add new assets but instead to use their cash to buy back their own stock," says Solon Patterson, president of Montag & Caldwell Inc., an Atlanta investment adviser. Indeed, the average stock price is now about 60% of the replacement value of the underlying assets. Thus, a company can acquire $1 worth of assets by paying about 60¢ for its shares. And despite soaring interest rates, borrowing to buy back stock makes sense because the debt will be paid off in ever-cheaper dollars that are tax-deductible to boot. Finally, by eliminating outstanding stock and the dividends on that stock, a company raises its earnings per share.

For investors, however, low stock prices remain a disincentive to buy. The only stocks that have done well recently have been hyper-growth stocks such as energy-related, gambling, high-technology, or fast-growing small companies. A decade ago, by contrast, the entire equity market was perceived as an inflation hedge. Then, in the early 1970s, large growth stocks, especially the so-called

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Robert S. Salomon Jr.
General partner, Salomon Bros.

"nifty fifty," were in vogue as inflation fighters—until the 1974 recession dealt them a blow from which they have yet to recover.

Unfortunately, hyper-growth stocks are not big enough to attract big institutional money. Private pension funds, for example, which control some $300 billion in assets and are the single most important factor in the financial markets, put more than 120% of their new cash into equities in the late 1960s. To do so, they even sold bonds to raise money to buy stocks. Today the amount of new pension money flowing into equities is a minuscule 13% as the funds have built up their cash portions or stuffed their portfolios with short-term securities paying high rates.

In short, the financial markets are so eccentric that for more than 10 years the largest returns have come from taking the fewest risks. Indeed, by constantly rolling over short-term paper, investors have beaten returns on stocks and bonds by a considerable margin. "That's not the way it's supposed to work," says an investment banker.

Undeniably, the U. S. is in the midst of a fundamental shift—aided by government monetary and fiscal policies—away from investment in favor of immediate consumption. "Savers are subsidizing borrowers, and debt has become more attractive than capital formation," points out Coleman of SMU. Indeed, the Japanese on average save 25% of their disposable income. Americans, by contrast, save 6%.

The low American saving rate has also been prompted by the astonishing rise in housing values, the proliferation of corporate pension funds, recent increases in the minimum wage, and beefed-up Social Security benefits. All of these have given people a sense of security that would have been unimaginable a generation ago.

Housing: The inflation hedge

Because of this new sense of security, both corporations and consumers have embarked on the biggest spending spree in history. Since the recovery began in early 1975, corporate debt has risen 36% to more than $1 trillion, while total debt has surged by 42% to nearly $4 trillion. More ominous, consumer installment debt is up 50% to $300 billion, and residential mortgage debt has also leaped by some 50% to $750 billion.

Housing, in fact, has become the most popular inflation hedge for most Americans. "For the past five years, real estate has been the equity market that stocks used to be," points out Allen Sinai, a vice-president of Data Resources Inc., a leading economic consulting firm.

Demand also has been spurred by government policies—and the financial muscle of the agencies that support housing—which have made mortgage money far easier to obtain. By far the single most important change has been the six-month savings certificates with floating rates pegged to the Treasury bill rate. Since the certificates were introduced just one year ago, some $160 billion worth have been sold, and this injection of funds has enabled lenders to keep the consumer spending boom rolling along. Through such innovations the government hopes to avoid cyclical downturns in the mortgage market that freeze out homebuyers and bring on recessions.

But, of course, this tampering with the credit markets has been putting upward pressure on interest rates, stimulating the debt-inflation spiral, and killing the equity market. "Today by far the largest and most rapidly growing component of the capital markets is represented by mortgage debt," says Salomon of Salomon Bros.

Important as it is, however, housing is only a part of the story. Indeed, billions of dollars also are growing into "alternate equity" investments, and none of them is growing faster than futures and options. Last year, for example, futures trading on all U. S. exchanges totaled 58.5 million contracts, up 36% from 1977 and more than double the 27 million contracts traded in all of 1974. The growth in options—contracts on stock prices very similar to the futures contracts on commodity prices—is even more astonishing. Since 1973, options volume has soared from 1.1 million contracts to 57.2 million contracts. Moreover, the trading edge of stocks over options is now a scant 2 to 1, compared with a 50-to-1 ratio as recently as five years ago.

The exploding markets are feeding a speculative fever that is very close to out-and-out gambling. Indeed, speculators in commodities lose on most trades and must rely on an occasional big win to put them ahead—something that no longer deters even conservative institutional investors. Gaasedelen of the Minneapolis Teachers Retirement Fund Assn., for example, intends to put some assets into "speculative ventures," where the returns are huge enough 20% of the

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time to offset the losses that occur the rest of the time.

And in addition to siphoning away equity capital from U. S. corporations, such trading is worrisome because it is so highly leveraged. In the Treasury-bill futures market a downpayment of $800 can secure a contract for delivery of $1 million worth of bills. A price movement of less than 1% can triple a speculator's downpayment or wipe him out, depending on its direction.

Originally, financial futures were intended to provide inexpensive protection against interest rate movements. But today there is great concern about what the futures market can do to the underlying market in Treasury issues, which, at $500 billion, is the largest and most stable financial market in the world. One fear is that the cost and timing of the Treasury's financings will be adversely affected. The specter was raised most vividly last September when a major securities firm took a position in futures equal to $3 billion in T-bills only a few days prior to an auction of new debt. The huge position inadvertently created the possibility of a shortage of deliverable bills to back up the futures.

Almost as fast growing as financial futures are the money market funds. In fact, the only reason the mutual fund industry has been able to survive the death of equities is the dramatic success of such funds, which invest in T-bills, bank CDs, and other short-term paper. Mutual fund assets now total some $65 billion, and of this amount, some $22 billion represents assets of money-market funds. And whereas stocks once made up 80% of mutual fund assets, today that figure has slumped to less than 50%.

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Minneapolis Teachers Retirement Fund Assn.

Clearly, money market funds—most of which allow investors to write checks on their accounts—will prosper until interest rates begin to ease. But even when rates do fall, the money will not flow back into the stock market from which it came. Indeed, putting life back into the U.S. equity market will be a long and difficult process. Says David Silver, president of the Investment Company Institute: "It would take a sustained bull market for a couple of years to attract broad-based investor interest and restore confidence."

In addition to winding down inflation, the government must also allow more realistic accounting practices and treatment of inventory profits. "The tax system unduly penalizes corporate earnings because it uses original cost depreciation instead of replacement cost," points out Beryl W. Sprinkel, executive vice-president and economist with Chicago's Harris Trust & Savings Bank. "And corporations report temporary inventory profits and pay tax on them, even though they're not real profits."

The tax system is equally burdensome on investors. For one thing, dividends are taxed twice—once as corporate profits and again as shareholder income. Moreover, "inflation has pushed middle America into the 40% and 50% tax bracket," says one Wall Street economist. "If you are in a decent tax bracket, there is not much incentive to invest in equities now."

The impact of taxes

For this reason, money has been pouring into the municipal bond market, even though the ratio of municipal to corporate yields is at an all-time low. "Individuals are investing in municipals to avoid taxation," adds the economist. Undoubtedly, some individuals are also investing in hard assets because profits are relatively easy to hide from the tax collector.

The impact of a tax cut can be seen in France, which passed a law, effective Jan. 1, 1978, that allows at least a $1,190 deduction from gross income for new

Wall Street looks beyond stocks

As investors have fled equities, so Wall Street, to survive, has fled them, too. Indeed, the flight from equities, combined with the freeing of fixed brokerage commission rates on May 1, 1975, has changed the very nature of the securities industry. And while the industry has markedly fewer firms than it had, and thus should be sounder financially, the truth is that Wall Street's future still is very much in doubt. "Anybody who thinks that it will be easy sailing for Wall Street during the 1980s is dead wrong," says James Balog, senior executive vice-president of Drexel Burnham Lambert Inc. in New York. "There still are many problems that we must deal with."

Most visible is what securities firms are doing to lower their dependence on the equities market. Obviously, the staggering growth of two of the industry's newest products—stock options and financial instrument futures—shows clearly the areas to which much of Wall Street is shifting its emphasis. While just a handful of Wall Street firms—such as Shearson Loeb Rhoades, Merrill Lynch, and E. F. Hutton—have enjoyed a sizable commodities futures brokerage business, that area now is becoming fair game for many others as well, including Salomon Bros. and Goldman, Sachs & Co. "In the most fundamental way, options and futures are ways securities firms can utilize a fixed overhead and spread that overhead over a wider volume base," says Samuel L. Hayes III, professor of investment banking at

Harvard Business School. "The profitability of these new businesses—when they are, in a sense, byproducts of an operation that is already in place—is very high."

Yet, for many of the firms, the diversification moves are coming much later than they should have. "Merrill Lynch has done the most diversification away from the general securities business. It has the greatest effort going," says Perrin H. Long Jr., an analyst with Lipper Analytical Distributors Inc. in New York. "Everybody else ranks a poor second."

Warning. If the majority of firms are late in getting started, it was not for lack of knowledge. Indeed, the warning signals were clear. While the disenchantment with equities probably had its roots in the steep market declines of 1972 and 1973-74, it was the removal of wage and price controls by President Nixon in 1973—and the resulting sharp climbs in both interest rates and consumer prices—that clearly nailed the lid on the coffin. In addition, the market decline of 1973-74 turned many institutional investors away from the one-concept system of investing strictly in growth stocks.

Merrill Lynch, however, saw the cloudy future. As early as the 1973-74 period, it moved into insurance, acquiring Family Life Insurance Co., and it has not stopped since. In fact, it has taken the diversification movement to new dimensions, moving into the real estate field with several purchases of local real estate firms as well as starting up its own relocation advisory service.

Oppenheimer & Co. and a number of other firms are ignoring the diversification strategy. Instead, these firms are taking to the acquisition route as a way of spreading the risk. Oppenheimer's attempts have not always been successful—its bid to acquire the assets of Checker Motors Corp. recently fell through, for example—but they have been plentiful. In the past three years alone, Oppenheimer has acquired three apparel manufacturers, a supplier for industrial vending-machine operators, a producer of construction materials, and a chain of specialty shops.

Ivan Massar/Black Star

Harvard's Hayes: For securities firms, options and futures mean high profits.

The test of how successful these strategies will be hinges on the success the industry has in dealing with its basic product—equities—and the pricing structure under which it operates, which favors institutions over individuals. Indeed, because the securities industry cannot stay afloat without the business that the giant, cash-laden institutions provide, Wall Street has simply been giving away its services to those customers since 1975.

As a result, compensating revenues have to be generated elsewhere, and the individual investors have had to bear the brunt. This predatory pricing structure requires that the nation's small individual investors—who have no clout—subsidize the institutional business, merely to keep the market liquid and the Street from going belly up.

Defectors. Unfortunately, the well from which the industry can draw commission income to subsidize its institutional business is drying up. Individuals are becoming less willing to pay steep commission penalties for stocks, and Edward I. O'Brien, president of the Securities Industry Assn., says that stock market commission revenues in the industry are down to about 42% of total revenues from between 50% and 60% in the last five years. Moreover, a number of investors are defecting to the slew of discount brokerage firms that has sprung up since 1975.

In the meantime, securities firms will continue to diversify away from equities, all the while hoping that the stock market will somehow regain some of its luster and make their task somewhat easier. At the same time, executives at those firms will be devising and implementing new long-term strategies, not really knowing whether they or their organizations will remain in the business long enough to reap the benefits from some of these plans.

purchases of French stock. Says Marc Auboyneau, a partner in Auboyneau-Labouret-Ollivier: "The law brought a large amount of capital into the market, and that influx is still continuing." During the past 19 months the Paris Bourse has soared by nearly 60%.

Other foreign stock markets such as those in Toronto, Hong Kong, and London have been doing as well or better. One reason is the influx of U. S. money that a decade ago would have flowed into Wall Street. Atlantic Richfield Co., for one, will invest in foreign stocks for the first time this year. The company will take 3% of its U. S. equity allocation and put it into shares of companies based in Japan, Germany, Britain, and France. "The attraction is that these economies are growing at a rate equal to or better than our own and have business cycles different from ours," says Howard H. Ockelmann, the big oil company's investment officer.

Undoubtedly, another reason for the surge of investment in foreign stocks is the negative attitude toward business in the U. S. "The Japanese do everything they can to make their strongest and most competitive companies do well. Americans attack their largest and most successful companies," says Andrew J. Hutchings, an equity manager for Royal Trust Co. in Toronto.

Institutionalized inflation

Leading the attack are government agencies such as the Environmental Protection Agency and the Occupational Safety & Health Administration, whose sometimes arbitrary regulations can cost companies unexpected—and enormous—amounts of money. "Twenty years ago you didn't have the government agencies that could change a company's rate of return tomorrow," points out Gershon N. Mandelker, associate professor of business administration at the University of Pittsburgh.

Mandelker further contends that the current Administration is capitalizing on this antibusiness sentiment. "People like to have villains, and Carter is blaming the oil companies for our economic problems," he says. "Inflation is caused by government printing money, not by sheiks raising oil prices."

Whatever caused it, the institutionalization of inflation—along with structural changes in communications and psychology—have killed the U. S. equity market for millions of investors. "We are all thinking shorter term than our fathers and our grandfathers," says Manuel Alvarez de Toledo, of Shearson Loeb Rhoades Inc.'s Hong Kong office.

Today, the old attitude of buying solid stocks as a cornerstone for one's life savings and retirement has simply disappeared. Says a young U. S. executive: "Have you been to an American stockholders' meeting lately? They're all old fogies. The stock market is just not where the action is at." ■