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THE ONLY GAME IN TOWN

by WALTER BAGEHOT

IT has been pointed out by Colyer Crum and others that financial institutions are dominated by organizational goals other than investment performance. George Goodman argued in his book, "The Money Game" that the securities business is an emotional business with a high degree of entertainment value for at least some of the participants. If Crum and Goodman are right, people presumably participate in the stock market because, like parlor games and sports, it offers the opportunity to win more dramatically and more concretely than is possible in ordinary workaday life.

On the other hand, academic studies (in particular the studies of Professor Michael Jensen of the University of Rochester) of professionally managed portfolios have shown not only that professional investors as a group fail to perform better than amateurs, but that it is even difficult to find individual portfolios which have achieved performance significantly better than neutral. On the basis of this kind of evidence it would appear that if participants in the stock market play to get the experience of winning, then the securities business is a very poor game indeed. Why does anybody choose to play the stock market game?

Another closely related question is why we observe wide swings in the enthusiasm with which people play the stock market game. The turnover rate on the New York Stock Exchange in 1968 was roughly twice what it was as recently as 1962. Every time one investor benefits from a trade, after all, another loses. If enthusiasm for the game is influenced by past successes or failures one would expect that, aggregated across the entire investing population, the level of enthusiasm as manifested in trading volume (or better yet, in turnover volume) would be very stable.

And, finally, why is it that among

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professional portfolio managers yesterday's heroes are so often today's goats?

The answer to all three questions lies, I believe, in a widespread confusion between market gains (and losses) and trading gains (and losses). It is, of course, possible to diversify a portfolio so completely that essentially the only investment risk remaining is market risk—that is, uncertainty regarding whether the market as a whole will move up or down. If the market moves up then investors in general will benefit from the market movement whether they are trading securities or merely holding what they have. But if they are trading while the market moves up, they are very likely to attribute the increase in their wealth to their trading activity rather than to the fact that the market has moved up. This is what I mean by confusion of trading gains with market gains.

The effect of the confusion is particularly noticeable in portfolios that are unusually sensitive to market movements. Portfolios invested in small, growing, highly levered companies, for example, are often so sensitive to market movements that a 10 per cent rise (or fall) in the general market level will cause a 20 per cent rise (or fall) in the value of the portfolio. When one manages this kind of portfolio it is very easy to convince oneself (and others) that one is a trading genius when the market is going up, and this is precisely what happened to a number of widely publicized mutual fund portfolios in the period between 1957 and 1965. On balance the market rose sharply in this period and the value of portfolios that were especially sensitive to changes in market level rose much more sharply. But their gains were market gains, not trading gains. Because these funds were trading actively during this period, however, their gains were attributed to trading and many other portfolio managers who had previously traded less actively began to emulate them.

The result was that beginning around 1964 and 1965 many types of equity portfolios that had previously traded very little suddenly perked up and began to trade very actively. A review of trading volume figures for individual investors will show that they behaved very similarly. If people confused market gains with trading gains it is easy to understand why they continued to play the stock market game even though their trading performance rarely departed from neutral.

THE MARKET MAKER—KEY TO THE STOCK MARKET GAME

Investors persist in trading despite their dismal long-run trading record partly because they are seduced by the argument that because prices are as likely to go up as down (or as likely to go down as up), trading based on purely random selection rules will produce neutral performance; therefore, trading based on any germ of an idea, any clue or hunch, will result in a performance better than neutral. Apparently this idea is alluring; nonetheless it is wrong.

The key to understanding the fallacy is the market maker. The market maker is the exchange specialist in the case of listed securities and the over-the-counter dealer in the case of unlisted securities. The role of the market maker is, of course, to provide liquidity by stepping in and transacting whenever equal and opposite orders fail to arrive in the market at the same time. In order to perform this function the market maker stands ready to transact with anyone who comes to the market.

One can discuss the economics of market making in terms of three kinds of transactors who confront the market maker: one, transactors possessing special information; two, "liquidity-motivated" transactors who have no special information but merely want to convert securities into cash or cash into securities; three, transactors acting on information which they believe has not yet been fully discounted in the market price but which in fact has.

The market maker always loses to transactors in the first category. A wide spread between the market maker's bid and asked prices will discourage transactors from trading on any special information that implies only a small change in equilibrium price; but because these transactors have the option of not trading with the market maker in such circumstances, he will never gain from them — unless of course they have misappraised their special information. It is evident that transactors with special information are playing a "heads I win, tails you lose" game with the market maker.

On the other hand the market maker always gains in his transactions with liquidity-motivated transactors. The essence of market-making, viewed as a business, is that in order for the market maker to survive and prosper, his gains from liquidity-motivated transactors must exceed his losses to information-motivated transactors. To the market maker, the two kinds of transactors are largely indistinguishable. The spread he sets between his bid and asked price affects both: the larger the spread, the less money he loses to information-motivated transactors and the more he makes from liquidity-motivated transactors (assuming that a wider spread doesn't discourage the latter transactions).

Unfortunately, the liquidity of a market is inversely related to the spread. The smallest spread a market maker can maintain and still survive is inversely related to the average rate of flow of new information affecting the value of the asset in question, and directly related to the volume of liquidity-motivated transactions. This is where the third kind of transactor comes in: from the market maker's point of view,

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his effect is identical to the liquidity-motivated transactor's. The market maker naturally welcomes the cooperation of wire houses and information services like the *Wall Street Journal* that broadcast information already fully discounted since many investors are easily persuaded to transact based on that information, hence enable the market maker to maintain substantially smaller spreads than would be possible without their trading activity.

THE MARKET CONSENSUS

It is well known that market makers of all kinds make surprisingly little use of fundamental information. Instead they observe the relative pressure of buy and sell orders and attempt to find a price that equilibrates these pressures. The resulting market price at any point in time is not merely a consensus of the transactors in the market place, it is also a consensus of their mistakes. Under the heading of mistakes we may include errors in computation, errors of judgment, factual oversights and errors in the logic of analysis. Unless these errors are in some sense systematic across the population of investors—or, to put it the other way around, to the extent that the commission of these errors is more or less statistically independent one investor from another—market price is virtually unaffected by these errors. This is a consequence of the law of large numbers: because the number of individual transactors is large and because their mistakes of judgment and estimation are likely to be independent, one transactor from another, the net effect of their mistakes on the equilibrium price is likely to be miniscule.

If, instead of seeking out the market price that equilibrates buying and selling pressures based on these appraisals, the market maker imposed his own judgment of what a security was worth, he would be risking an error of his own of the same order of magnitude as the errors committed by other investors. It is not surprising in this light that market makers generally have so little use for fundamental considerations in their work. This observation also points up the futility of trying to trade profitably by making unusually conscientious, thorough or sophisticated security analyses. The ultimate in sophisticated analysis is not likely to improve on the accuracy of the market consensus.

When the role of the market maker is as described here, the market maker can be viewed as a conduit through which money flows from liquidity-motivated transactors to transactors with special information. This result follows directly from the original observation that in order to stay in business the market maker must earn more from liquidity-motivated transactors than he loses to transactors with special information. Every time one transacts against the market maker he incurs a 'spread cost' in addition to any explicit brokerage commission. The size of the effective spread on listed stocks is hidden because oscillations between 'bid' and 'asked' are camouflaged by the constant fluctuations in the equilibrium value of the stock. If trading volume is small, and insiders' profits are large, the spread cost incurred in transacting is necessarily large, however. Whereas it is indeed true that the transactor is as likely to gain as lose from fluctuations in equilibrium value, what he loses in trading against the spread must be large enough to provide insiders with their profits, and hopefully leave something for the market maker besides. This is why trading on hunches or rumors is more likely to degrade performance than improve it.

COPPERING THE PUBLIC

The question is sometimes asked, if trading by the general public is so futile then why isn't trading against the public consistently profitable? The answer lies in the special manner, just described, in which the public loses. If all trading took place between those who got information early and those who got it late, then one could make money by trading against those who get it late. But if our picture is accurate, those who get information early make their profits from the market makers, who in turn make *their* profits from those who trade without genuinely new information. If the public traded directly against insiders, one could deduce which way insiders were trading by observing which way the

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Exercises for Reader

Will market making be more profitable in good markets or bad markets?

Will market makers resist or welcome suppression by SEC and others of use of inside information?

Into which of the 'three categories' fall those transactors who base their trading decisions on 'conscientious, thorough or sophisticated' security analysis?

Is sophisticated analysis valuable to transactors with inside information?

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scribed above, is to adopt a "passive" portfolio strategy. If an investor does this, then he won't try to outguess turns in the market. He won't try to pick individual stocks that he thinks will do better than other stocks.

He will buy a well diversified portfolio, and hold on to it. He will generally sell only to establish tax losses, or when he needs the money. He may borrow against his portfolio when he needs money, instead of selling, to avoid realizing capital gains. He will minimize investment expenses, brokerage costs, and taxes.

Only a relatively large investor can afford to buy stocks directly.

An investor who invests only a few hundred dollars at a time can often do better buying shares of a mutual fund rather than buying his own stocks.

Diversification is very important to a passive portfolio strategy, and the brokerage costs on small purchases of a large number of stocks can be as high as 18 per cent in and out. Thus the small investor, depending on his circumstances, may be better off in a mutual fund, which may give him 50 to 100 stocks at a time. But he can still try to choose a fund that follows a strategy that approximates a passive portfolio strategy.

A passive strategy is not the same as random selection. I am not suggesting putting the financial page of the newspaper on a bulletin board and throwing darts at it.

It is important for the investor to choose a well diversified portfolio, and it is important for him to choose a portfolio that fits his objectives, including his tax status and his ability to tolerate fluctuations in the value of his portfolio. But once he has a portfolio, he should make changes only to keep it diversified, to fit it to changing objectives, to generate cash, or to realize tax losses.

Whether he is an amateur or a professional, giving up the attempt to do fundamental analysis will mean that his portfolio performance, especially his after-tax performance, will most likely be better than that of other professionally managed portfolios.

The first step, however, is for the investor to convince himself that the strong form of the random walk hypothesis is true. And this is very difficult for most investors to do. ♦

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public was trading (as, for example, with odd-lot information). It is true that the public loses quite consistently on its trading (as opposed to investing—as we noted, it is entirely possible to remain invested without trading), but it loses because it is trading against the market maker's spread. The public would lose just as much if at every point in time the direction of its trading were the reverse of what it actually is; hence there is no value in coppering the public.

This argument exaggerates the 'spread' problem for those listed stocks that have an active auction market. How active the auction markets for NYSE stocks are can be judged, however, from the fact that in recent years Exchange members were transacting for their own accounts on one side or the other of two out of three transactions. ♦

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