About the Economy

Protect the Public: Reinstate Glass-Steagall

To protect the public, we need to separate America's banking system from the brokerage (investment banking) industry as it was for seventy years under the now repealed Glass-Steagall Act. Complex derivative securities created by brokerage firms collapsed in recent months causing the biggest worldwide financial crisis in decades. Problems with investment securities should not be allowed to threaten our public banking system.

President Bush's plan to overhaul the nation's financial regulatory system is a move in the wrong direction. His proposal, a response to the country's economic crisis, would merge the regulatory bodies of the banking and brokerage industries, the Fed and the SEC, and further weaken regulation. I believe that recent de-regulatory legislation is a major cause of the economic crisis the world is facing today. Rather than continuing on the ill-fated route of banking/brokerage integration and deregulation, I believe the public and the world economy would be better served by moving in the opposite direction: reinstate the Glass-Steagall Act and re-establish the separation between banking and brokerage.

The Glass-Steagall Act was originally adopted in 1933 as a response to the 1929 Market Crash and Great Depression. The Act mandated the separation of the banking and brokerage industries by prohibiting a commercial bank from offering investment and insurance services. The purpose of this landmark legislation was to protect the nation's banking system and the cash deposits of the people of this country from the speculative excesses of the brokerage industry. In 1999, the Gramm-Leach-Bliley Act (the "Financial Privacy and Modernization Act") was signed into law. This law establishes important consumer protections of financial privacy. However, the legislation dismantled another important public protection:-the protection of our banking system by the repeal of the Glass-Steagall Act.

The argument used for removing the distinction between banking and brokerage was that despite the law, institutions had found "side routes" to creating "financial integration" and the many combined financial institutions we see today. These mergers could have been modified or even stopped had the Fed enforced regulations that existed at the time. According to the Federal Reserve Bank of San Francisco Newsletter (FRBST Economic Letter 2000-10 March 31, 2000) the Act "breaks down barriers—some of which are seven decades old—and allows full affiliation of banking with underwriting and agency activities in securities and insurance." The Act also clearly places responsibility squarely on the Fed for monitoring the credit risk exposure of these integrated institutions.

The second piece of legislation that unhinged regulation and led to the current credit crisis was the Commodity Futures Modernization Act. It was introduced on the floor of the Senate by Phil Gramm, who was then chairman of the Senate Finance Committee, and signed into law in 2000. This law completely deregulated the market for "complex derivatives" allowing banks and brokerage firms both separately and together to speculate in this thoroughly unregulated market.

We've all heard about the sub-prime mortgage-related derivatives that sparked the collapse. It's important to broaden our perspective and understand that mortgage-related derivatives account for only a portion of the complex derivatives market. This market, the size of which is actually unknown, has been estimated at between $300 trillion and $700 trillion dollars. At $300 trillion this market billion this market exceeds 15 times the value of the entire US Stock Market (approximately $20 trillion). It exceeds over 30 times the entire US Public Debt. This gigantic market is entirely unregulated thanks to the Commodity Futures Modernization Act. It's possible that the credit derivative market exceeds in value the assets they represent. There is indeed much confusion about the inherent or implied value of these securities.

It is important to note that both of these laws were spearheaded by Phil Gramm, former Republican Senator from Texas and key advisor to John McCain. He is potentially positioned to serve as Treasury Secretary if McCain becomes President.

It is also important to note that while Alan Greenspan argues his innocence in the matter, he did nothing to halt financial integration, allowed the repeal of the Glass-Steagall Act and indeed championed the Commodity Futures Modernization Act of 2000, heralding its supposed benefits. There is little true regulation in the incestuous relationship between the Fed and the Industry. Here are Greenspan's remarks (May 5, 2005, Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure):

"In the United State, the Commodity Futures Modernization Act of 2000 has permitted healthy competition between the exchanges and the OTC markets, and both sets of markets are reaping the benefits. The benefits are not limited to those that use derivatives. The use of a growing array of derivatives and the related application of more-sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions…."

There are people who will argue that any regulation hinders the workings of the free market economy. But no one argues that the privacy protections of the Gramm-Leach-Bliley Act threaten the free market economy. No one argues that the FAA should not regulate the Airline Industry and protect public safety in the air (although recent Congressional hearings have exposed a similarly incestuous relationship). No one should get away with the argument that regulation of our banking system and protection of the public economy from those who choose to speculate in complex derivatives will ruin our free market economy.

Speculation is an inherent part of the workings of a free market economy and will always exist. At the same time, it is imperative that the public banking system not be threatened by these speculative activities. We should not wait until the economy is as bad as it was in the Great Depression to be motivated to create real regulatory reforms that are deeply rooted in the protection of the public trust. That is one lesson and one remedy that I think we should consider right now in light of the current worldwide "credit crisis." Don't Wait – Reinstate!!

Investment Portfolios

Of course with all the concern about the economy, it is hard to "stay the course" with your investments. I research and study and if I could find an alternative, I would implement it. I can't help but think about all the investment meetings I went to listening to people touting the advantages of "hedge funds." Hedge funds were supposed to be a silver bullet against risk and now the hedge funds have basically imploded due to the risks they took on. There is no silver bullet. If there were, I would use it.

This is from an interview with Warren Buffett from CNN Money on April 14, 2008:

> CNN: What should we say to investors now?
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> Buffett: the answer is you don't want investors to think that what they read today is important in terms of their investment strategy. Their investment strategy should factor in that (a) if you knew what was going to happen in the economy, you still wouldn't necessarily know what was going to happen in the stock market. And (b) they can't pick stocks that are better than average. Stocks are a good thing to own over time. There's only two things you can do wrong: You can buy the wrong ones, and you can buy or sell them at the wrong time. And the truth is you never need to sell them, basically. But they could buy a cross section of American industry, and if a cross section of American industry doesn't work, certainly trying to pick the little beauties here and there isn't going to work either. Then they just have to worry about getting greedy. You know, I always say you should get greedy when others are fearful and fearful when others are greedy. But that's too much to expect. Of course, you shouldn't get greedy when others get greedy and fearful when others get fearful. At a minimum, try to stay away from that.
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> CNN: By your rule, now seems like a good time to be greedy. People are pretty fearful.
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> Buffett: You're right. They are going in that direction. That's why stocks are cheaper. Stocks are a better buy today than they were a year ago. Or three years ago.
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> CNN: But you're still bullish about the U.S. for the long term?
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> Buffett: The American economy is going to do fine. But it won't do fine every year and every week and every month. I Mean, if you don't believe that, forget about buying stocks anyway. But it stands to reason. I mean, we get more productive every year, you know. It's a positive-sum game, long-term. And the only way an investor can get killed is by high fees or by trying to outsmart the market.

I think it is important, when listening to the market news, to understand that the stock market is a leading economic indicator, not a lagging indicator. That means, the stock market goes up then there is a recession and the stock market rebounds and then the economy recovers from the recession. It is impossible to know when that is going to be. If you wait until the economy recovers to invest in stocks again, it is going to be too late.

I haven't made any broad changes in allocation between stocks and bonds. The problem with moving out of the market is not being able to know in advance when the market will turn up. Our portfolios are already diversified across a wide range of investments in size, type and geography.

Cash Investments

I have answered a lot of questions from clients about where to hold their cash investments. At least a couple people have called me to ask if I think they should take money out of banks. I have done a lot of reading and a lot of thought on this matter. There are some considerations here, including questioning the soundness of banks that have been participating in complex derivatives and have "written down" billions of dollars of debts as a result. Here is what I think.

First of all, years ago I decided that "asset backed" (derivative) securities had no place in a bond fund when the bond position of the portfolio was there to anchor the safety side of the allocation against the equity side. I researched many of the popular bond funds at the time, including all of the bond funds I was using in client portfolios. That is why I have concentrated on using Vanguard, DFA and T Rowe Price bond funds – I know they are not using derivatives, or if so only sparingly. I have stayed strictly away from High Yield Bonds, Bond Funds, Long or Short-Term.

This past month many people were shocked to watch the Schwab Yield Plus Fund, a short-term bond fund generally recommended as a "safe" investment, implode as a result of high risk derivative investing. It was shocking enough for Fidelity to come out with a statement about how they manage their Money Market Funds – conservatively. And indeed, no Money Market has ever "broken a dollar" or failed.

I recommend, and have recommended for a long time, Vanguard Prime Money Market Fund to hold the majority of cash reserves. Fidelity Money Market is where we hold cash in investment accounts, which is also managed conservatively. Federally-Chartered large banks can be used for convenience for checking accounts. I am, however, conducting some research regarding State-Chartered Banks as I have more confidence in State than Federal regulation of the banking industry.

