Betting It All On the Market

Why America is wrong to wager its future on Wall Street

BY JOSEPH NOCERA

A FEW WEEKS AGO—the same week, as it happens, that the Dow Jones Industrial Average topped the 6,500 mark, after the biggest one-month climb in stock market history—*The New York Times* Sunday magazine put a picture of a mutual fund manager on its cover. His name is Michael P. DiCarlo; he is 40 years old, and since 1988 he has been running something called the John Hancock Special Equities Fund—one of the hotter "small cap" funds around, with an eye-popping annualized return of more than 25 percent over the past five years.

The story inside turned out to be a very long profile of DiCarlo, in which we learned, among other things, that despite the market's extraordinary—some might say, gravity-defying—run these past few years, DiCarlo remains extremely bullish: "The next five years will be the most significant time to really accumulate wealth this country has ever seen," he boldly proclaimed. We learned that he has a putting machine in his office; that at the age of 19 he bought a house with money he had made booking rock bands; and that he had survived a brain tumor when he was 20. In other words, we learned the sorts of things one reads in celebrity profiles. Which, when you think about it, is what the story was.

And of course we learned about his favorite market sectors (energy and technology), and his favorite stock, America Online—a stock that has been tanking for the better part of the last six months. It was, in fact, DiCarlo's travails with AOL that formed the narrative heart of the story: Would the stock rebound? Would it continue to sink? Would DiCarlo's table-pounding faith in it turn out to be his biggest triumph or his downfall? (What the story didn't mention was that giving DiCarlo so public a forum as the *Times* to talk up the virtues of AOL was bound to help the stock in the short term. But that's a story for another day.) All of this was told with the sort of dramatic flourishes normally reserved for crime stories. That the flourishes didn't really work—I can tell you from personal experience how hard it is to dramatize a guy sitting in a room watching stocks going up and down on a screen—was almost beside the point. A mutual fund manager betting it all on a volatile, risky stock is something most of us have come to understand and appreciate in our bones. It is, after all, our money he's risking.

Hardened market cynics will no doubt view the appearance of a mutual fund manager on the cover of the *Times* magazine as the surest sign yet that the end is near for this, the greatest bull market in U.S. history—a 14-year span that has seen the Dow rise nearly 6,000 points. And who knows? Maybe that's how it will turn out. Maybe someday we'll look back on the fall and winter of 1996 and wonder how we could possibly have missed all the signs that the bull was winding down. But then, that's the way it is with the stock market. Its every twist and turn is always obvious—in retrospect.

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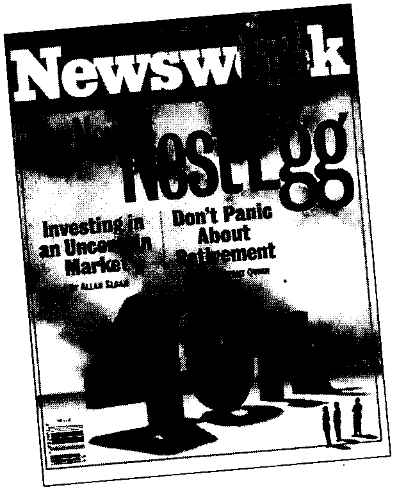
And a year or so ago—back when the Dow was a mere 5,000—that probably would have been my reaction too. But now the article provoked in me a different set of concerns. I found myself wondering not so much what the article signaled about the health (or lack thereof) of the current bull market, but rather what it said about us, and the financial culture (for lack of a better phrase) we've created and embraced. Indeed, what struck me most about the story was the way it unconsciously underlined the extent to which we've become obsessed with personal finance—with markets and mutual funds and every last tick of the Dow Jones average. The story simply presumed, for instance, that the readers of the *Times* magazine were inherently interested in the daily life of a fund manager, and it was full of terms of the trade that the author never bothered to translate—taking it for granted that her readers already knew what they meant, that they had become part of our common language. Most of all, there was an underlying, but unmistakable, assumption running through the story that all this stuff—the movement of the Dow, the doings of a mutual fund manager, this stuff we never used to think about, much less care about—now mattered to us deeply, because it affects the lives of a huge portion of the American middle class.



This assumption, of course, is correct. The statistics are absolutely clear: More than a third of American households now have money in the market—a stunning percentage that ranks right up there with the number of households that have personal computers. And it's serious money these households have put into the market, money people really can't afford to lose. That may be the most worrisome thing of all about the financial culture we've created: A large percentage of the American public is betting that their prospects for a better life will come not from their jobs or their talents, but from their willingness to ride a hot fund manager or a hot stock as far as it can carry them.

Riding the Bull

Let me take a moment here to stress what I am not arguing. I am not suggesting that average Americans are too dumb or too flighty to participate in the stock market, or that this is the sort of thing that is best left to the experts. Given the fact that 80 percent of the nation's mutual fund managers don't beat the basic market indexes, that would be a rather difficult thing to argue in any case. But the 1990s have also been a time when the small investor has tended to act more rationally and calmly than the big boys on Wall Street. Even now, with the Dow reaching such unprecedented heights with such unprecedented speed, the small investor has shown very little of the euphoria that usually characterizes a market mania. Yes, they are throwing money into mutual funds at a record pace, but they are doing so mainly because they feel they have no choice. And if you spend any time talking to these investors—which I've done a fair amount of lately—you come away realizing that they are more nervous than gleeful. To a surprising degree, it is Wall Street that's euphoric while Main Street remains cautious.

I am also not arguing that we should go back to the days when the middle class was supposed to keep its money in the bank while rich people played the markets. In the 1920s and 1930s, of course, the markets were unapologetically an insider's game, led by the likes of J.P. Morgan; small investors were not only scorned, but their business was actively discouraged. As recently as the 1970s, when inflation was raging, government policy—led by Paul Volcker, first as a Treasury bureaucrat and then as chairman of the Federal Reserve Board—was specifically geared toward keeping middle-class savings in the bank; even such mundane inflation-beaters as Treasury notes were out of the financial reach of most Americans. This policy eventually crumbled because people were absolutely unwilling to allow their money to be eroded by inflation when the rich had the means to keep pace with it. It seems unarguable to me that if we're going to have stock markets—or Treasury notes, for that matter—they ought to be available to everyone, not just the wealthy. One of the more underrated, but revolutionary, things that happened in the 1980s was that the rise of the mutual fund—which allows small investors to pool their capital while a professional money manager invests it—democratized the stock and bond markets.

What I do find worrisome are the less obvious, and more insidious, side effects of the bull market. First, there is the simple fact that we're no longer merely rooting for the bull market to continue; by now, we have come to count on it to provide some of the real basics of middle-class life in America—from the education of our kids to our retirement. When you think about the historic attitude Main Street has taken towards the stock market—that it was something to be feared, rather than embraced—this is an astonishing development. It is also a troubling one.

Second, there's the question of whether it is healthy for us to be spending so much of our energy thinking about our money, whether it diverts us from productive activities. When we get up in the morning and hear that the Japanese markets have been hit hard—a piece of once-arcane news that is now regularly featured on most morning news shows—that news can cast a pall, at least until we find out how our markets react to their markets. Many companies provide employees with software that allows them to check on a dozen or more different stocks as often as they want to during the day. Aside from pornography, stock-related chat rooms may well be the single most popular aspect of the Internet; there are people who spend literally hours each night discussing their favorite stocks over the Internet. And these are just the small diversions. An entire industry has grown up, seemingly overnight, consisting of magazines, TV shows, and newsletters, all purporting to give us investment advice. And then, of course, there is the biggest diversion of all: our own portfolio, over which we can (and often do) endlessly obsess.

But the most subtle, and in some ways the most insidious, question of all is whether the bull's great run has, in effect, become a kind of national tonic, allowing us to avoid tackling any number of pressing problems. To my mind, the best example of this is the recent proposal to reform Social Security by investing part of the Social Security trust fund in the stock market. That, of course, isn't really a reform at all, but simply a bet that the bull market will make up the inevitable Social Security shortfall. If only it were that simple! But that's where we are, 14 years after this bull began. A hundred years ago, newcomers to our shores put their faith and dreams in the idea of America; today, we've put our faith and dreams in the stock market.

Wall Street Rising

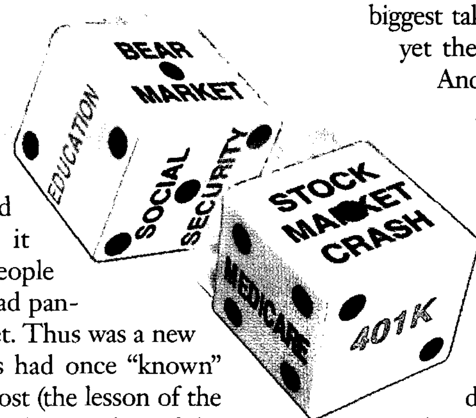
So where did this financial culture of ours come from—this world where the stock market is a national obsession, and fund managers are minor celebrities—and how did it insinuate itself into our lives? The surprising answer is that it is not purely a function of living through a decade-and-a-half bull market, though that's certainly helped. The 1950s saw its own torrid bull market (until just a few years ago, that was the greatest bull market of the century). Yet that earlier run-up never had the same galvanizing effect on the country; even as late as 1959, barely 10 percent of the country was invested in the stock market. Mostly, people greeted that bull market with a yawn—if they noticed it at all.

The comparison with the 1950s is instructive for another reason. One reason people tended to stay away from the market then was that they were of the generation that had grown up in the Depression, and that incredibly powerful memory helped keep them away. The Depression taught the lesson that financial risk was to be avoided at all cost; the stock market—even an up market—was thought to be nothing if not risky. But another reason was that people didn't *need* the market the way we feel we need it today. You could live a decent life—buy a house, raise a family, take a vacation, send your kids to college, and enjoy retirement—without having to make money in the market. In terms of personal finance, at least, it really was a simpler time: Inflation was negligible, raises were steady, and pensions were reliable. In general, most people kept their money in the bank where it earned an interest rate of, oh, 4 percent or so. But 4 percent was fine. People had no compelling reason to seek more than that, so they didn't.

Though nobody seemed to notice at the time, the seeds of the new financial culture were first sown during the inflation of the 1970s. This is when middle-class Americans began to think seriously about what they did with their money. Inflation forced them to do so. One important example: Interest on bank passbook accounts was stuck at 5 1/4 percent—by government fiat—while "real world" interest rates were approaching 20 percent; that meant people were actually losing money by keeping it in the bank. Gradually, as more and more Americans woke up to this fact, they began moving their money out of the banks and into money market funds, which offered those higher interest rates, and which were run by the brokerage houses and mutual fund companies. Between 1979 and 1982, when inflation finally subsided and the bull market began, money market funds went from holding less than $10 billion to over $250 billion. That was not the money of the wealthy, but the money of the middle class, and never again would it return to the bank.

But if inflation started this process—if it helped bring about this new mindset, in which it was vitally important to pay attention to what was happening to one's money—it had a lot of help along the way. In fact, it's almost as if everything that has happened subsequently has only conspired to further that process. Once inflation subsided, for instance, along came the beginning of this bull market, which offered people the alluring prospect of the double-digit returns they had become used to when interest rates had been so high. Mutual funds, such as Fidelity Magellan, posted fabulous numbers in the early 1980s, which drew press attention—and middle-class money. (Magellan's Peter Lynch became the first "celebrity" fund manager.) The era of the raiders and junk bonds and hostile takeovers stoked interest in the stock market—and in the idea that you could make fast money there. The price of a house—which had been going up for well over a decade, so much so that people had started assuming that it would go up forever—began to fall, which furthered the sense that nothing could be taken for granted anymore, not when it came to one's money.

Even the famous crash of 1987, when the stock market fell more than 500 points in one day, pushed things along. Rather than causing people to flee back to banks with their money, the crash, in the end, caused people to embrace the market with renewed fervor. Why? Because this crash, unlike the one of 1929, did not lead to a new Depression. On the contrary, within 15 months the market had earned back every penny—and it kept going up. Ultimately, the people who felt foolish were those who had panicked and gotten out of the market. Thus was a new lesson learned. Just as Americans had once "known" that risk was to be avoided at all cost (the lesson of the 1930s), just as they had once felt it almost a law of the universe that houses appreciated 15 percent a year (the lesson of the 1970s), so did they now "know" that when the market went down—even when it went down 500 points in a day—they should simply invest more heavily. The lesson of the 1987 crash was that the market will always bounce back. So far, at least, nothing has come along to dissuade people of that lesson.



J.T. MORROW

But all the while, as the market was making its fabulous gains, year after year, there was another side to our personal finances that was less pleasant to contemplate. Think about what's been happening in the "real" economy during this same decade and a half. The raiders boosted stock prices, all right, but they also began the process of downsizing that continues to this day. Regular gains in productivity—which had been the engine driving the 1950s economy—came to a crashing halt in the 1970s. That meant that companies had to stop giving out automatic raises, which meant that people began to have a harder time making ends meet. Even after inflation was tamed, one big cost that never got back under control was college tuition. So whereas Americans could once live a pretty good life on one salary, by the 1980s that was much more difficult. One way people coped with this new situation was to send both spouses into the workplace. But another way was to begin investing more seriously—and looking to the market as a way to make up some of the difference.

There was one other change taking place, in some ways the most startling of all. Companies that had once paid for the retirement pensions of their employees began shifting the burden of paying for retirement onto their employees. This is the broad move to so-called 401(k) plans, wherein an employee gets to pick his or her own retirement investment vehicle (from an array of options offered by the company)—and then funds it with his or her own money. There are two things that I find especially striking about the move to 401(k) plans. The first is that this must surely rank as one of the biggest takeaways in American history—and yet there has been no outcry, no debate. And the reason for that, I'm convinced, is that we've been blinded by the bull market. So long as the market keeps rising 15 and 20 percent a year, we have been willing to acquiesce to this enormous change. If and when it stops rising at that rate—if and when it ever starts going down, heaven forbid, and takes our retirement nest egg down with it—well, by then it will be too late to complain.

The second striking thing is that in the mid-1990s, 401(k) money has become the single dominant factor driving the stock market right now. There is very little dispute about this. When you read in the paper each month that the nation's stock funds have received an influx of $15 or $20 billion, the vast bulk of that money is retirement money, coming into the funds via 401(k) plans. There is now $800 billion in 401(k) plans (and $3 trillion—that's right, *trillion*—in mutual funds altogether), and that sum grows with every passing day. Fidelity Magellan alone now gets around 70 percent of its new money from 401(k) plans. People are pouring money into the market like there was no tomorrow—but not because they're giddy or euphoric. It's because they feel they have no choice.

Bowing Down to the Dow

And so here we are living in a world where the stock market has become, if not central to our lives, then damn close to it. I was struck by how powerful a force it has become some months back when I met a couple in upstate New York named Russ and Sharon Gornie. Russ owns a small carpet-laying business; his wife serves as the office manager, and because her three kids are still too young to go to school, she often takes them to work with her. Once there, her attention constantly shifts from the kids to the television, which is always tuned to CNBC—the NBC-owned cable station that, during the day, delivers nothing but financial news. "I could watch this all day long," said Sharon—and indeed she does.

Russ and Sharon are at the lower end of the middle class, clearly struggling to make ends meet. Yet they are ardent investors, on the prowl for the big score. For awhile, they owned Microsoft—one of the greatest growth stocks of all time, of course—but more recently, they sold their stake in Bill Gates' enterprise and invested in two small tech stocks, which are much, much riskier than Microsoft. Three or four times a day Sharon would call a phone number where she could get an update of the price of her two volatile stocks.

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When Sharon was asked why this activity made more sense to her than, say, trying to build the carpet business, she was adamant. "We're working so hard," she said, "and we're just not getting there fast enough." The stock market, she was convinced, could get her "there." "Everybody's making so much money in the market," she said, almost wistfully. "Everybody's getting rich." Later she pulled out some architectural drawings of a big house—her dream house. "It's an incentive," she said. But, more than anything, it is an incentive to invest, since she's convinced she will never be able to afford the house from the proceeds of the business. When Russ was asked about investing, he smiled and shrugged. "It's scary, but what are you going to do?"

Meanwhile, Sharon's mother Dorothy, laid off from IBM several years ago, is also an avid investor. "I'm only a few years away from retirement," she said. The market, she is convinced, is her only hope of having anything to retire with.

I suppose if you're a market man, like Jack Kemp, say, such wondrous faith in the stock market is a heartening thing. But I find it depressing—and in no small part because Russ and Sharon's almost childlike belief in the stock market is so widespread these days. It's depressing more, though, because of what it suggests about the new American financial culture. Work is ever-so-slightly demeaning—especially blue-collar work—whereas the stock market is a much quicker, even surer, route to the good life. (Another woman told me, "It's cleaner, there are no other people involved, and it doesn't take nearly as much time as my real job.") I saw another example of the same thing earlier this year when I began tracking a stock called Iomega on the Internet; as the stock rocketed upward, its investors conveyed the clear sense that they were smarter than other people, that they somehow deserved their new wealth, that they'd never have to work again—and wasn't that just great! (Of course when the stock then came crashing back down to earth, they blamed not themselves, but evil Wall Street, which they believed had conspired to punish them for their success.) Meanwhile, those who don't invest fret that they are being played for suckers, or being left behind. The stock market has gone, in less than 20 years, from being a sideshow for most Americans to being the main event.

Think of all the different ways this plays out in society. We freely accept the once heretical notion, to cite one particularly telling example, that the shareholder is the most deserving participant in our capitalist economy—simply because he bought shares in a company. Thus we accept the absurd idea that CEOs must be given multi-million-dollar stock options in order to "incentive-ize" them (as if doing a good job isn't enough of an incentive)—and we applaud when they keep down labor costs, which boosts the stock price. Someone like the boorish "Chainsaw Al" Dunlap, newly installed as CEO of Sunbeam, becomes a folk hero because of the ruthlessness with which he turns around troubled companies; his latest, widely applauded move was to announce the firing of fully half the workers of Sunbeam. Naturally the stock price shot up. We find ourselves rooting for our portfolios rather than the greater good. Sometimes, people even cheer their own layoffs if it will be good for the stock price. I met such a woman recently, a former vicepresident of Citibank who had been laid off, but had held on tenaciously to her Citicorp stock, convinced that it was going to go up. It did—from $12 a share to $89 a share, and she was ecstatic. Never mind that the company had taken away a job she had truly loved, and work that had been deeply meaningful to her. She had made money in the stock. What else mattered?

Even government economic policy is being crafted more and more with the stock and bond markets in mind. Who, after all, wants to be the president to get blamed for bringing to an end the greatest bull market in history? Even liberal Democrats morph into rock-ribbed Republicans when it comes to economic policies that will keep the bull market going. Capital gains tax? Getting rid of it will boost stock prices—so who needs it? The economy is getting "too good?" By all means, slow it down if it will keep the stock market chugging along.

Let me mention a couple of other ways our new obsession with the stock market is now warping the larger society. Yes, it's true that fully a third of us are now investors, but that still means that two-thirds of us are not. Just as the information age has helped further the division between haves and have nots, the stock market is doing the same. Those who can invest at least still have their hopes and dreams—and if they pick a poor investment, they tend to hitch up their belts and start again. (No one retreats back to the bank. In the modern age, the bank is for losers.) Those who can't invest are left out; this seemingly wonderful thing remains forever out of their reach—to their lingering resentment. And then there's the weird anomaly that we seem to be promoting a new kind of meritocracy based on (of all things) one's ability to pick stocks. Should anyone's chances at a decent life really depend on such a skill? To ask this question is to answer it, of course. But we've become so sucked into this new financial culture we don't even see that this is a question we should be asking.

Yet instead of pulling back from this financial culture, we rush headlong to put even more of a burden on the stock market. I am speaking here, of course, of the upcoming proposal from a blue-ribbon panel to invest a portion of the Social Security trust fund in the market. In this one proposal all our bull market delusions are laid bare: our belief that the bull will never end; our implicit hope that the market can allow us to avoid tackling the hard issues; and our almost comical embrace of the stock market as our friend.

Investing a portion of the Social Security trust fund is so fraught with peril that the fact that it is being seriously contemplated astonishes me. Suddenly, the entire government will be watching the Dow's every tick the same way we individuals do now. There would be nothing the government wouldn't do to keep the bull stoked—no matter what the outcome to the rest of the economy. For any politician hoping to be reelected, nothing would be more vital than sustaining the bull market. And when the market did take a tumble, the political consequences would be terrible—as would the financial consequences for retirees now clamoring for this change. Yet the country is so convinced that the market, over time, can only go up, that we simply can't contemplate any other outcome.

It is a dangerous game we're playing. The more we imbue magical powers to the market, the less we credit other aspects of a fulfilling life, such as work we love or creating something beyond the paper wealth of the stock market. And the more we ask of the market—the more we count on it to get us the retirement we want, to send our kids to college, and all the rest of it—the more we're asking for trouble in the long run. The stock market doesn't have broad enough shoulders to prop up all of America and carry it forward, and it was never meant to do so. The market was created as a means to provide capital for companies, in return for which investors could expect, if all went well, a decent return. It was never supposed to be, as financial historian Ron Chernow put it recently, "our national piggy bank and retirement account." If there are problems with Social Security; if the cost of college is getting absurdly high; if our longer life span is making the prospect of a well-funded retirement increasingly out of reach—these are all issues we should face squarely. The rising market has created the illusion that it can take care of these problems, and more. But it can't.

It won't last, you know, and that's the other, more basic, reason why we're on such dangerous turf. I'm not saying it can't run for another three or even 10 years—or that the Dow won't get to 8,000 or 10,000 or beyond before it comes back to earth. But this bull market will end, as every other bull market has eventually ended. Already, stocks are largely overvalued, and the market is being driven more by the sheer amount of money we're throwing into it than by fundamentals. And when it does end, we'll all learn a new economic lesson, as we turn our back on the market we now embrace. I can't say I'm looking forward to that day—where do you think my own retirement money is?—but I think it will be a healthy thing for all of us. We need to start thinking about how to fix the problems that the bull market can't. ●

Of Inhuman Bondage

The bond market has policymakers in its grip

BY AMY WALDMAN

STANLEY DRUCKENMILLER does not come across as a life-of-the-party kind of guy. He rarely gives interviews, but when he does the word "dour" is the inevitable modifier. One profile reported that he went to bed at 8:30 p.m. on weekends. But for Druckenmiller, a lack of color is no hindrance to being heard: When he talks—or bets—Congress listens.

The Manhattan-based protege of billionaire George Soros, Druckenmiller reportedly earned $700 million last year. He now manages Soros's money, as well as that of other gold-plated investors. Managing, for Druckenmiller, does not involve looking for good rates of return on bank deposits. It involves taking the millions of Soros or his clients, borrowing even more, and then making enormous bets on the direction of stock, bond, and currency markets worldwide. He is, in short, a speculator of leviathan proportions, part of a small elite of money managers with such large stakes in the markets that their decisions to buy or sell can move those markets.

Or move Congress. After the Republicans took Congress in 1994, Druckenmiller wagered that the GOP would curb spending and force a balanced budget deal. For Druckenmiller, a bet was not a ten-spot with some friends; it meant buying millions of dollars in Treasury bonds. As James Glassman subsequently reported in *The Washington Post*, Druckenmiller speculated that the market would react favorably to a balanced budget deal, because as the government needed to borrow less, bonds would become rarer and thus more valuable. If the market bid up bonds in anticipation of that happening, he would make a killing.

His perfectly spun plan snagged on Bill Clinton, however, who resisted the Republican cuts and started warning of the dangers of a default because of the GOP refusal to raise the debt ceiling. The Republicans seemed poised to let a balanced budget deal slip away. So Druckenmiller began telling his Republican friends in Congress—and as a man who had given $250,000 to the Republican National Committee in 1994 he had a lot of friends—that the financial markets would tolerate any means to the end of balancing the budget, including a default. The cost of a "train wreck," Druckenmiller insisted, would be minor compared to the benefits of balancing the budget.

In September of 1995, Senator Pete Domenici (R-NM), the chairman of the Senate Budget Committee, flew to New York for a dinner at Seagram House with a dozen contributors, mostly large fund managers. Druckenmiller was among them. He told Domenici that the market would trade around a default if there were a balanced budget agreement. Domenici carried that message back to Capitol Hill. Newt Gingrich began broadcasting the same message, telling a meeting of the Public Securities Association—the bond industry trade group—that a balanced budget would be worth the price of a default. Druckenmiller and another big investor also bought a full page ad in *The Washington Post* that said, "let's not allow fears of temporary 'market instability' to serve as an excuse for equivocating on spending cuts ... If the markets