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The Process of Promises

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Here is a hypothesis to explain the extraordinary bull market of our times. For most of financial market history until some time in the 1960s, the stock market was primarily the domain of wealthy individuals. Banks, insurance companies, endowments, trusts, and the proverbial widows concentrated on bonds.

The crescendo of pension fund money that developed during the 1960s injected a fundamental change into the character of equity investing. The defined-benefit pension funds made contractual promises that necessitated calculating a *required* rate of return. Investors had always aimed to grow richer, but only insurance companies had ever considered how much money an investor *must* earn.

Charitable foundations were the next group to join in. Like most investors, the foundations had given little thought to required returns, but many foundations were exploiting a tax loophole that enabled donors to control their companies while sheltering their shares from estate taxes and the dividends from income taxes. During the 1970s, Congress ordered foundations to distribute annually 5% of foundation assets or pay taxes.* Now earning 5%-plus-inflation became an obligatory investment objective. The educational endowments soon followed suit by setting forth explicit investment objectives and systematic spending rules.

Solutions create problems. In order to fulfill all these promises, investors piled into assets with high expected returns, but the soaring asset values that investors proceeded to inflict upon themselves complicated the task of meeting required return objectives. Rising prices felt so good that the negative implications of higher prices for prospective returns carried little weight. Anyway, what other choice was there?

The only way to keep those promises was to take on even greater risk. Conventional bond exposure shriveled, cash turned into trash, emerging markets became irresistible, junk bonds sold at diminishing premiums over Treasury yields, and the accumulation of exotic and less liquid assets was rationalized. The limits of the efficient frontier stretched further and further.

Then came the 401(k) phenomenon, propelled by the swelling cohort of baby boomers and associated fears about Social Security. Once upon a time, life began at forty, but in the 1990s, forty was when you began worrying about retirement. Suddenly, millions of novice investors were told to think about investment in terms of promises — only the promises were to themselves rather than someone else. You are the last person you would want to disappoint.

To many investment neophytes, "taking on risk" has meant investing in stocks, but "taking on risk" appeared to have little to do with the risk that the rising stock market was diminishing the probability that these individuals would be able to keep their promises

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to themselves.

This process of promises has colored investing with an unparalleled sense of urgency. Why is buying on dips a great idea in the 1990s when it never was before? Even with the 1987 experience to look back on, stepping up to the plate after a steep sell-off is scary under any circumstances. Sheer determination rather than pure and simple courage must be driving the buy-on-dips strategy.

In a world where decision-making is on automatic pilot, careful calculations of valuation and probable expected returns will provide amusing intellectual recreation but may turn out to be irrelevant for the execution of successful investment strategies. The shock that can turn the tide under these conditions will have to be substantially larger and more sustained than any of the disturbances that have attacked the economic and financial environment over the past twenty years.

ENDNOTE

[*]The requirement was originally 5% of assets or 100% of income, whichever was greater.

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REMINDER

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