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Financial Markets: Truth and Consequences

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We often hear assertions such as, "The purpose of the markets for financial instruments is the efficient allocation of scarce means to alternative uses through the pricing of income streams and risks." We may even read this in textbooks.

I take strong exception. Such a vision of the economic system is flawed. This statement fails even to hint at a more realistic assessment of "the purpose of the markets for financial instruments."

People never come together to establish markets for the purpose of allocating resources. Who would have bothered to go to that fateful meeting under the Buttonwood Tree just because someone said, "Hey, let's set up a stock exchange so that we can more efficiently allocate scarce means to alternative uses through the pricing of income streams and risks"? The gathering under the Buttonwood Tree had no such objective in mind, just not at all. The goal was simply to provide a site for investors to trade bonds and shares—some to buy, and some to sell. A marketplace is where buyers and sellers find one another to do business and negotiate their respective interests.

The allocating function of markets is only a by-product, although a miraculously useful one. Because markets set prices—that is what they are all about—they do provide signals of where the quantities demanded exceed the quantities offered for sale, and vice versa. But there is no reason markets must be the only institution to allocate scarce resources to alternative uses. As Ronald Coase emphasized many years ago, the corporation allocates internal resources without any market mechanism to guide its decisions. Governments do it in socialist systems.

Oh, yes, the notion that participants in markets are performing the noble macroeconomic function of resource allocation sprinkles a kind of holy water over the hurly-burly and egocentricity of their daily work. That is why those words ring with such a lovely tone. On the other hand, altruistic buyers or sellers who enter markets for any reason other than to seek the best price for what they wish to sell, or to pay the lowest price for what they wish to buy, will soon fade from view with empty pockets, holy water or not.

The purpose of financial markets is to provide immediate liquidity—otherwise known as the present value of future cash flows, both certain and uncertain. Markets enable investors to realize cash on debt instruments before those instruments mature and to realize cash on instruments like stocks with no maturity date. Although there are many other future sources of cash flow, such as rent from a tenant or McKinsey's stream of consulting fees, these flows have no path into immediate liquidity without paper tradable in financial markets.*

Markets are two-way institutions, however. Impatient investors who want to eat their cake today can do so, kindness of markets, but only at a price that buyers find fair compensation for their patience. Without markets, all financial instruments are buy-and-hold.

Direct owners of business firms always have access to their companies' cash flows and have no need of a market for that purpose. But once ownership becomes a minority position, and especially when it is a small minority position, only two sources provide a return to the shareowner: cash flows from the company like dividends and share repurchases, or the marketplace itself. The larger the cash flows, the less important the market. But as cash flows tend to be a small fraction of the value of the ownership, a marketplace is crucial for minority owners who might want to reduce the inherent infinite horizon of an equity to something less than infinity.

Now what happens when future cash flows such as dividends or buy-backs are so uncertain or so far distant as to have negligible present values? Then markets become the only reservoir of liquidity for minority owners. *But markets are nothing more than other investors.* Consequently, owning equities without palpable future cash flows makes sense under only one condition: that there will be an infinite supply of greater fools on into the infinite future. The trouble is that the investors who have bought such equities have already played the role of the greater fool when they made their original purchases. They should know whereof they seek!

*Yes, some assets can be turned into cash through bank loans, but loans have to be repaid.