Submission
to
Parliamentary Joint Committee on Corporations and Financial Services
Inquiry into Financial Products and Services in Australia
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ASIC says it believes that "markets operate most efficiently when there is a <u>minimum of regulatory intervention</u>. So, in short-hand form, this might be termed the <u>efficient market theory</u>."

Why is this a potential problem for Australia's future?

Recommendations:

- We need to introduce more regulation of financial markets. Key regulatory reforms to include:
  - Applying Paul Volcker's key recommendations to Australian regulation would change the shape of financial institutions in Australia for the better. These changes would help create a "financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort." (Volcker):
    - **<u>The commercial banks.</u>** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management.
    - **<u>The capital market system.</u>** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
    - Since **<u>some Australian insurance companies are "too big to fail"</u>**, they would have to be regulated more tightly too.
  - Banning securitisation of debt.
- To help protect consumers from Storm Financial or West-point style losses, we need to create a **<u>Financial Planner Registration Board</u>** (FPRB) – requiring higher education standards and a requirement that advisor acts in the best interests of the client. The goal would be to register only quality financial planners delivering "acceptable" advice. A discussion paper on how a FPRB might work is attached.

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This submission has been hurriedly thrown together – and is far from polished or complete – as this is a very big topic that requires very detailed analysis and consideration. However, I believe the issues raised here need to be considered by the inquiry, because they have potentially grave implications for the Australian economy.

<u>Table of contents:</u>

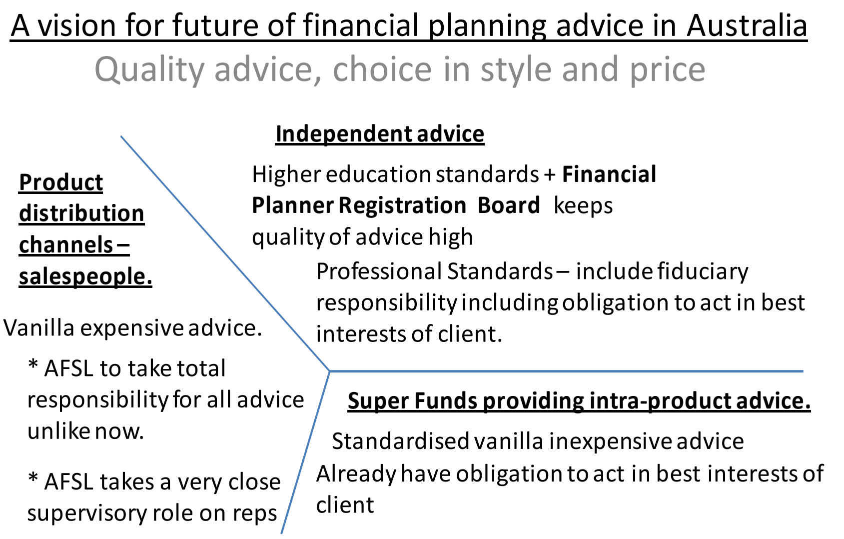
Primary Recommendations:

1. **Adopt Paul Volcker's** (http://en.wikipedia.org/wiki/Paul_Volcker) **recommendations to reform regulations to prevent this style of economic crisis in Australia's future. Also ban securitisation.**

In the West, we have lived through a period guided by a *"philosophy that markets knew best"*. This philosophy was a major contributing factor to the current global economic crisis. Even Alan Greenspan has conceded that his free-market ideology shunning regulation was flawed (see below). I am concerned that from ASIC's opening statements that they continue to rely on this philosophy - that *"markets operate most efficiently when there is a minimum of regulatory intervention"*. However, I note that in his 25/July/2007 essay in the Sydney Morning Herald, Kevin Rudd said *"The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad. This fundamentalist ideology of self-regulating markets has imploded comprehensively with the current crisis."* Therefore, I would hope that Kevin Rudd looks at the opening statement in the first hearing of this PJC inquiry (see Appendix A) and take the appropriate corrective action.

2. **Support the creating of a Financial Planner Registration Board.**

From ASIC's comments at the first hearing of this PJC inquiry, ASIC seems to be promoting "vanilla" advice (See Appendix J) as a way for consumers to avoid investment losses like that seen with Storm Financial and Westpoint. By "vanilla" advice I am drawing the conclusion that ASIC means index investing – because the advice promoted by the big institutions which ASIC was promoting, recommend index-hugging advice – and most of the funds offered (by dollars invested) by the big institutions are index hugging.



While index investing (at index fund prices of around 0.3%pa) would be better than much advice that is currently on offer, it is still not an optimal outcome for consumers. As you will see from the material provided below, there is a lot of evidence that the efficient market hypothesis is flawed and that there are a range of other competing approaches to investing that have merit. Why, therefore should consumer's be forced down one theoretical potentially flawed path while there are other paths that potentially offer a better approach. To help protect consumers from Storm-style & Westpoint-style investor losses, I recommend the creation of a Financial Planner Registration Board (FPRB)with the following features:

- designed by accounting professional bodies and BFPPG with ASIC input.
- Not compulsory. Many current financial planners would not qualify.
- Higher education and an obligation to act in best interests of the client.
- product manufacturer-owned planners can be registered but have no say in the FPRB because it is critical that the FPRB stay outside the control or influence of product manufacturers and their distribution arms.
- The FPRB to have a panel of professional independent advisors who will form views of what is acceptable advice, what is high risk advice and what is unacceptable advice.
- FPRB would define what is "acceptable" advice and this would evolve as investment theory evolves.

<u>Four Page Summary of this submission.</u>

1. Foreword. Paul Volcker on global financial crisis. “I will not accept the Nuremberg excuse.”

2. ASIC's philosophical basis for regulation of financial planners and markets.

- “markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention.”
- “the efficient market theory”

Though, we could view these two as one and the same belief, I will deal with these 2 issues separately. This will help lift the discussion above the sometimes emotional debate about Efficient Market Theory.

3. “Markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention”.

- **George Soros** “blames many of the world's problems on the failures inherent in what he characterizes as market fundamentalism.”
- **Longview Institute** “Market Fundamentalism is the exaggerated faith that when markets are left to operate on their own, they can solve all economic and social problems. Market Fundamentalism has dominated public policy debates in the United States since the 1980's”
- **Alan Greenspan conceded that his free-market ideology shunning regulation was flawed. 23/10/2008**
- **Richard Karn** identifes market fundamentalist polices that have been pursued in the USA over the last ten years
- **<u>Recommendation 1: Apply Paul Volcker's recommendation to Australia.</u> Paul Volcker**'s recommendations to reform regulations to prevent this style of economic crisis in Australia in the future. Specifically in February 2009, Paul Volcker's recommendations distilled down and applied to the Australian context would recommended the following changes to Australian regulation.
  - **<u>The Commercial Banks.</u>** The core of the Australian financial system needs to be built around commercial banks:
    - which the government will protect,
    - whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit. They ought to be the core of the credit and financial system, and
    - that must be more closely supervised and regulated and those institutions should not engage in highly risky entrepreneurial activity.
    - These commercial banks must divest themselves of highly risky entrepreneurial activities such as offering hedge funds, offering equity funds and proprietary trading. Largely these commercial banks would simply focus on deposit taking and providing credit.
  - **<u>The capital market system.</u>** Capital market players are dealing with each other. They’re trading. They’re about hedge funds and equity funds. They don't need to be so highly regulated. They’re not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
  - Applying Paul Volcker's key recommendations to Australian regulation would change the shape of financial institutions in Australia for the better. These changes would help create a “financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort.” (Volcker):
    - **<u>The Commercial Banks.</u>** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management.

- **<u>The capital market system.</u>** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
- Since **<u>some Australian insurance companies are "too big to fail"</u>**, they would have to be regulated more tightly too.

- **<u>Recommendation 2: Securitisation of debt needs to be banned.</u>** The biggest problem with securitisation is that it removed a critical tool from the tool-box of central banks. Historically, one tool central banks have been able to control the money supply with has been by imposing reserving requirements on banks. By doing this, central banks could control the Money Mutiplier (see http://en.wikipedia.org/wiki/Money_creation#Money_multiplier) which controlled how much money could be created through the banking system. However, with securitisation, the lending institutions could get a new loan off their balance sheets and hence the Money Multiplier in effect became infinity. This tool to control the money supply needs to be restored to central banks – by banning securitisation of debt.

3.1. Grantham argues that even Greenspan knew there should be a limit to market fundamentalism – but that Greenspan did not have the courage or the ethics to follow through on his convictions.

- "Nothing threatens economic stability more than the deflating of a major stock market bubble."
- "In 1966 he (Greenspan) had written scathingly of the consequences of weak-kneed behavior by the Fed in 1928 and the dire consequences of delayed and weak action for everyone in the ensuing crash"
- "For his book The Great Crash (John Kenneth **Galbraith**, The Great Crash, 1929, pp. 189-194, New York, Mariner, 1997), concluded his analysis with a resounding vote that the Federal Reserve did indeed have ***the tools to prevent a major bubble but argued presciently it seems that such tools would never be used!***"
- "It will always look, as it did to the frightened men on the Federal Reserve Board in February 1929, like a decision in favor of immediate as against ultimate death. As we have seen, the immediate death not only has the disadvantage of being immediate but of identifying the executioner"
- "Greenspan's remarkable September 1996 statement to fellow Open Market Committee colleagues, '***I recognize that there is a stock market bubble problem at this point. We do have the possibility of increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it.***'"
- "***For a Federal Reserve boss to have volunteered to have taken a lot of political heat and certain short-term damage to his reputation without a realistic hope of offsetting rewards simply because it was the right thing to do would have taken very high ethical standards and considerable strength of character. Paul Volcker perhaps might have made that choice.***"
  - Note: Through the same period where Greenspan has been implementing policies he knew to be wrong, because he was not prepared to accept the consequences of the alternative, financial planners and fund managers were also facing the same dilemma. Many acted against the best interest of their clients for precisely the same reason that Greenspan did – because of what is known in the industry as "**career risk.**"

3.2 **"Greenspan Concedes to `Flaw' in His Market Ideology"** Bloomberg Oct. 23 2008

- "Alan Greenspan ..... conceded that his free-market ideology shunning regulation was flawed."
- "Greenspan acknowledged he was 'partially' wrong for opposing the regulation of derivatives over the years."
- "The admission that free markets have their faults was a shift for the former Fed chairman who declared in a May 2005 speech that 'private regulation generally has proved far better at

constraining excessive risk-taking than has government regulation.'"

- "Waxman echoed that sentiment to Greenspan: *'The mantra became (that) government regulation is wrong. The market is infallible.'*"
- "Greenspan opposed increasing financial supervision as Fed chairman from August 1987 to January 2006. Policy makers are now struggling to contain a financial crisis marked by record foreclosures, falling asset prices and almost $660 billion in write-downs and losses tied to U.S. subprime mortgages.
  Greenspan, 82, reiterated his 'shocked disbelief' that financial companies failed to execute sufficient 'surveillance' on their trading counter-parties to prevent surging losses. The 'breakdown' was clearest in the market where securities firms packaged home mortgages into debt sold on to other investors, he said."

3.3 Kevin Rudd "fundamentalist ideology of self-regulating markets has imploded". SMH 26/7/09

- "As I have argued elsewhere, the boom-and-bust economic cycle of the past decade has been an unavoidable consequence of a decade of neo-liberal free market fundamentalism that reinforced a culture of corporate greed and excess in the financial sector. The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad.
  This fundamentalist ideology of self-regulating markets has imploded comprehensively with the current crisis."

4. Efficient Market Hypothesis (EMH). The EMH is flawed.

- If markets were efficient, then there would be no stock-pickers like George Soros, Kerr Neilson & Warren Buffett who, over decades, have added value by picking stocks - delivering better than market average performances. Yes, from time to time a fund manager might outperform over a significant period of time – but there are some who do it through stock-picking skill etc.
- Summary of the Efficient Market Hypothesis. http://en.wikipedia.org/wiki/Efficient_market_hypothesis#cite_note-0
- **Jeremy Grantham:** "When you believe in ***market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving***. It's ruinously expensive."
- **Bill Gross**, "The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking."
- **AFR. Central banks using flawed models. Regulators need to review assumptions.**
- **Professor Lo of MIT – EMH remained influential because of 'physics' envy.'**
  - "Behavioural finance has grown to become a popular alternative approach precisely because it does appear to explain more clearly how investors, individually and collectively, appear to act."
  - "The real beauty of the efficient markets hypothesis, and the explanation for its longevity in the face of consistent empirical evidence that it is invalid, surely lies in its beguiling simplicity."
  - "The biggest problem with this new approach, as with all alternatives to EMH, including behavioural finance, is that it doesn't give investors a simple metric for understanding what to do. Its great merit, however, is that it appears to relate to the complex and uncertain world that we all actually inhabit, something the efficient markets hypothesis has never done."
- **"Myth of the Rational Market - A History of Risk, Reward, and Delusion on Wall Street "**
  - "The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the ***efficient-market hypothesis***. This theory holds that stock and bond markets are nearly perfect -- even during such crazes as the dot-com mania -- and that prices on the exchanges instantly and accurately reflect the available information

about publicly traded securities. After the market crash of 1987, **Yale University economist *Robert Shiller*** called that belief ***'the most remarkable error in the history of economic theory.'*** *He could have said 'most harmful error' as well.* Yet it lived on and contributed mightily to the mortgage bust."

- "How did this faith in the supremacy of market group-think do us harm? For one, as the dot-com and other manias demonstrated, the crowd occasionally gets it wrong. The mistaken faith in markets turned regulators into fawning groupies. Notably, former Fed chairman Alan Greenspan doubted that he or anyone else could detect -- or regulate -- a bubble in advance."
- "In particular, the theory of **option pricing**, the cornerstone of modern finance, **has built into it the assumption that prices are random**. The theory was devised by Fischer Black, ***Myron Scholes*** and ***Robert Merton***. The last two won the Nobel Prize in 1997 and were partners in ***Long-Term Capital Management, the hedge fund that blew up in 1998*. What happened to LTCM?** It turned out that in financial markets, extreme events do happen."

In summary:

- Many leading thinkers in investment markets & economics believe that the Efficient Market Hypothesis is fatally flawed. As you can see from above, Jeremy Grantham goes as far as to say that it can be very dangerous for investors to believe in market efficiency because "it's like being on the railroad watching the locomotive coming toward you." This is precisely the way many investors have behaved over the last 2 years through this global financial crisis – to their detriment.
- Even Eugene Fama, the father of efficient market theory, has moved on from his thinking in the 1960s. Fama & French is the early 1990s came up with the Three Factor model which better explains the actual behaviour of investment markets. And Fama can see potential for other factors to help explain the actual behaviour of markets eg momentum.
- Behavioural finance is a major emerging framework that clearly can be seen to operate in markets. Markets aren't physics. Maybe no one model explains them.
- Yes, we can see efficient market effects at work in markets. We can also see behaviourial effects in markets. Despite this ASIC seems to be strong promoting/advocating "vanilla" investment advice – based on the flawed assumption that the Efficient Market Theory and the Capital Asset Pricing Model are robust and can be relied on. This is likely to produce a suboptimal outcome for consumers.

  Recommendation 3: A better solution for consumers would be if we created a Financial Planner Registration Board (with a panel of expert independent [i.e. not conflicted] practicing financial planners) which would determine what acceptable advice was – and that this definition of "acceptable" advice could evolve as investment theory evolves – as it continually will evolve. This Financial Planner Registration Board would also help consumer's avoid losses as has occurred with Storm Financial and Westpoint. The Financial Registration Board (FPRB) would have the following features:
  - designed by accounting professional bodies and BFPPG with ASIC input.
  - Not compulsory. Many current financial planners would not qualify.
  - Higher education and an obligation to act in best interests of the client.
  - product manufacturer-owned planners can be registered but have no say in the FPRB because it is critical that the FPRB stay outside the control or influence of product manufacturers and their distribution arms.
  - The FPRB to have a panel of professional independent advisors who will form views of what is acceptable advice, what is high risk advice and what is unacceptable advice.
  - FPRB would define what is "acceptable" advice and this would evolve as investment theory evolves.
- A discussion paper on how the FPRB might work is attached.

5. Fama 11/2007 Three factor model replaces Capital Asset Pricing Model. Sees potential for further evolution of theory.

1. Foreword - Paul Volcker on the global financial crisis. "I will not accept the Nuremberg excuse."

http://network.nationalpost.com/np/blogs/fullcomment/archive/2009/02/17/paul-volcker-the-banking-world-needs-more-canadas.aspx
from 11/2/2009 speech by Paul Volcker on the financial crisis. Paul Volcker was the chairman of the United States Federal Reserve from 1979-1987. He is currently the chairman of the US Economic Recovery Advisory Board. (economic advisor to President Barack Obama.)

"You might ask how it went on as long as it did. The grading agencies didn't do their job and the banks didn't do their job and the accountants went haywire. I have my own take on this. There were two things that were particularly contributory and very simple. *Compensation practices had gotten totally out of hand and spurred financial people to aim for a lot of short-term money without worrying about the eventual consequences. And then there was this obscure financial engineering that none of them understood, but all their mathematical experts were telling them to trust. These two things carried us over the brink.*

One of the saddest days of my life was when my grandson – and he's a particularly brilliant grandson – went to college. He was good at mathematics. And after he had been at college for a year or two I asked him what he wanted to do when he grew up. He said, "I want to be a financial engineer." My heart sank. Why was he going to waste his life on this profession?

A year or so ago, my daughter had seen something in the paper, some disparaging remarks I had made about financial engineering. She sent it to my grandson, who normally didn't communicate with me very much. He sent me an email, ***"Grandpa, don't blame it on us! We were just following the orders we were getting from our bosses."*** *The only thing I could do was send him back an email,* ***"I will not accept the Nuremberg excuse."***

There was so much opaqueness, *so many complications and misunderstandings involved in very complex financial engineering by people who, in my opinion, did not know financial markets. They knew mathematics.* ***They thought financial markets obeyed mathematical laws. They have found out differently now.*** You know, they all said these events only happen once every hundred years. But we have "once every hundred years" events happening every year or two, which tells me something is the matter with the analysis.

So I think we have a problem which is not an ordinary business cycle problem. It is much more difficult to get out of and it has shaken the foundations of our financial institutions. The system is broken."

2. ASIC's philosophical basis for regulation of financial planners and markets.

In its opening remarks at the the first public hearing of Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services, ASIC said (Appendix A):
"I am going to address the general regulatory environmental and look at the underlying economic philosophy that lies behind the relevant part of the Corporations Act. That philosophy is that **markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention**. So, in shorthand form, this might be termed the **efficient market theory**—being a quiet pragmatic reliance on financial markets driving efficiency and with intervention addressing market failures."

I would like to examine this statement, because it states a belief system that may be problematic for Australia in some serious ways.

To examine this statement, I wish to break the above statement into two halves:

- **"That philosophy is that markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention."**
- **"this might be termed the efficient market theory—being a quiet pragmatic reliance on financial markets driving efficiency and with intervention addressing market failures."**

Though, we could view these two as one and the same belief, I will deal with these 2 issues separately. This will help lift the discussion above the sometimes emotional debate about Efficient Market Theory.

3. "Markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention".

To examine this statement, let me provide some statements from others:

- First some views from **George Soros,** probably the world's most success speculator, which requires a very good understanding of markets:
  - "Despite working as an investor and currency speculator, he argues that the current system of financial speculation undermines healthy economic development in many underdeveloped countries. **Soros blames many of the world's problems on the failures inherent in what he characterizes as market fundamentalism.**" http://en.wikipedia.org/wiki/George_Soros
  - "In an interview regarding the economic crisis of 2008, (George) Soros referred to it as the most serious crisis since the 1930s. **According to Soros, market fundamentalism with its assumption that markets will correct themselves with no need for government intervention in financial affairs has been 'some kind of an ideological excess'**." http://en.wikipedia.org/wiki/George_Soros

- Second, some views of the **Longview Institute** (see Appendix E): http://www.longviewinstitute.org/projects/marketfundamentalism/marketfundamentalism
  - "Market Fundamentalism is the exaggerated faith that when markets are left to operate on their own, they can solve all economic and social problems. Market Fundamentalism has dominated public policy debates in the United States since the 1980's, serving to justify huge Federal tax cuts, dramatic reductions in government regulatory activity, and continued efforts to downsize the government's civilian programs."

  http://www.longviewinstitute.org/projects/marketfundamentalism/myth4
  Market Myth Four: Financial Markets Thrive when Regulation is Kept to a Minimum
  - "When the capital development of a country becomes the by-product of a casino, the job is likely to be ill done."... "Market fundamentalists have reconstructed U.S. capital markets along the lines of a casino for the last two and a half decades." ... "Hedge funds - large pools of money that are free to pursue very risky investment strategies because they fall under a loophole in the system of financial regulation - are one of their key achievements."

- **US House Committee on Oversight and Government Reform hearing – Greenspan's free market ideology flawed.**
  http://www.bloomberg.com/apps/news?pid=20601087&sid=an8vy29bsXk8&refer=home
  - "Oct. 23 2008 (Bloomberg) -- Former Federal Reserve Chairman **Alan Greenspan** said a 'once-in-a-century credit tsunami' has engulfed financial markets and **conceded that his free-market ideology shunning regulation was flawed. 'Yes, I found a flaw,' Greenspan said** in response to grilling from

the House Committee on Oversight and Government Reform. ... **Greenspan acknowledged he was 'partially wrong for opposing the regulation of derivatives over the years.** ... Greenspan opposed increasing financial supervision as Fed chairman from August 1987 to January 2006."

  - **"Waxman (**Chairman**,** House Committee on Oversight and Government Reform) **said that he believed that the Federal Reserve, which regulates banks, the SEC and the Treasury had all played a role in contributing to the mistakes."**

- Fourth, in his **1/7/2009 paper "Credit and Credibility" Chapter 1, Richard Karn** (Emerging Trends Report) identifies market fundamentalist polices that have been pursued in the USA over the last ten years that have resulted in:-
  - "the unrestricted movement of capital across international borders;
  - the repeal of the Glass-Steagall Act separating commercial and investment banking operations;
    - http://en.wikipedia.org/wiki/Glass-Steagall_Act – The Glass-Steagall Act of 1933 established the Federal Deposit Insurance Corporation (FDIC) in the United States and included banking reforms, some of which were designed to control speculation. The Glass-Steagall Act was a set of measures intended to prevent another major crisis like the Great Depression
  - a congressional ban on credit-default swap (derivative) regulation;
  - a tripling of the amount of leverage allowed by investment banks;
  - the curtailment SEC regulatory enforcement;
  - an international agreement to allow banks to measure their own level of risk;
  - and the diminished capacity of international regulatory bodies to stay abreast with the rapid pace of financial innovation."

- I would like you to compare and contrast these 7 points of market fundamentalism identified by Richard Karn with the **Paul Volcker**'s recommendations to deal with reforming regulations to prevent this style of economic crisis. Paul Volcker is a former **U.S. Federal Reserve Board chairman (1979-1987)** when he is credited with ending the USA's stagflation crisis in the 1970s at a time of the next worse US economic crisis over the last 50 years. Paul Volcker is now a member of President Barack Obama's advisory team on the economy. http://network.nationalpost.com/np/blogs/fullcomment/archive/2009/02/17/paul-volcker-the-banking-world-needs-more-canadas.aspx

1. "In the future, **we are going to need a financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort.** Financial systems always fluctuate and go up and down and have crises, but let's not have a big crisis that undermines the whole economy.
2. And if that's the kind of financial system we want and should have, **it's going to be different from the financial system that has developed in the last 20 years.**
3. What do I mean by different? I think **a primary characteristic of the system ought to be a strong, traditional, commercial banking-type system.**
4. Probably **we ought to have some very large institutions** – or at least that's the way the market is going – **whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit.** They ought to be the core of the credit and financial system.
5. This kind of system was in place in the United States thirty years ago and is still in place in Canada, and may have provided support for the Canadian system during this particularly difficult time. I'm not arguing that you need an oligopoly to the extent you have one in Canada, but **you do know by experience that these big commercial banking institutions will be protected by the government, de facto.** No government has been willing to permit these institutions, or the creditors and depositors to these institutions, to be damaged. They recognize that the damage to the economy would be too great.
6. What has happened recently just underscores that. And I think we're at the point where we can no longer fool ourselves by saying that is not the case. **The government will support these institutions, which in turn implies a closer supervision and regulation of those institutions, a more effective regulation than we've had**, at least in the United States, in the recent past. And that may involve a lot of different agencies and so forth. I won't get into that.
7. But I think it does say that **those institutions should not engage in highly risky entrepreneurial activity.** That's not their job because it brings into question the stability of the institution. They may make a lot of money and they may have a lot of fun, in the short run. It may encourage

pursuit of a profit in the short run. But it is not consistent with the stability that those institutions should be about. It's not consistent at all with avoiding conflict of interest. **These institutions that have arisen in the United States and the UK that combine hedge funds, equity funds, large proprietary trading with commercial banks, have enormous conflicts of interest.** And I think **the conflicts of interest contribute to their instability.** So I would say let's get rid of that. Let's have big and small commercial banks and protect them – it's the service part of the financial system.

8. And **then we have the other part, which I'll call the capital market system**, which by and large isn't directly dealing with customers. **They're dealing with each other. They're trading. They're about hedge funds and equity funds.** And they have a function in providing fluid markets and innovating and providing some flexibility, and I don't think they need to be so highly regulated.
9. They're not at the core of the system, **unless they get really big. If they get really big then you have to regulate them, too.** But I don't think we need to have close regulation of every peewee hedge fund in the world.
   So you have this bifurcated – in a sense – financial system that implies a lot about regulation and national governments. If you're going to have an open system, you have got to get much more cooperation and coordination from different countries. I think that's possible, given what we're going through. You've got to do something about the infrastructure of the system and you have to worry about the credit rating agencies.
10. **These banks were relying on credit rating agencies while putting these big packages of securities together and selling them. They had practically – they would never admit this – given up credit departments in their own institutions that were sophisticated and well-developed. That was a cost centre – why do we need it, they thought. Obviously that hasn't worked out very well.**
11. **We have to look at the accounting system. We have to look at the system for dealing with derivatives and how they're settled. So there are a lot of systemic issues.** The main point I'm making is that we want to emerge from this with a more stable system. It will be less exciting for many people, but it will not warrant – I don't think the present system does, either -- $50 million dollar paydays in that central part of the system. Or even $25 or $100 million dollar paydays. If somebody can go out and gamble and make that money, okay. But don't gamble with the public's money. And that's an important distinction.
    It's interesting that what I'm arguing for looks more like the Canadian system than the American system. When we delivered this report in a press conference, people said, '**Oh you mean, banks won't be able to have hedge funds? What are you talking about?'** That same day, **Citigroup announced, 'We want to get rid of all that stuff. We now realize it was a mistake. We want to go back to our roots and be a real commercial bank.'** I don't know whether they'll do that or not. But the fact that one of the leading proponents of the other system basically said, 'We give up. It's not the right system,' is interesting."

<u>Conclusions:</u>

Clearly, Paul Volcker is not a free market fundamentalists (efficient market hypothesis zealot) like successive US Fed chairmen Alan Greenspan or Ben Bernanke. That is, Paul Volcker knows that the right way forward is for government to implement a well-design regulatory system that can kerb the excesses that can occur in markets – excesses that if left unchecked can cause a global financial crisis like the current global financial crisis that we are currently experiencing!!!!! Paul Volcker has now offered us, the key features of what he regards as a better regulatory framework going forward. Australia needs to take Paul Volcker's advice and implement similar regulatory changes here in Australia – because Australia faces the same risks as the USA.

<u>So in summary:</u>

- Please note that Paul Volcker's recommendations to deal with reforming regulations to prevent this style of economic crisis. These recommendations seek to wind back the excesses of market fundamentalism which are characterised by phrases such as **"That philosophy is that markets drive efficiency and that markets operate most efficiently when there is a minimum of**

regulatory intervention."

- **<u>Recommendation 1: Implement Volcker's recommendation in Australia.</u>** Australia needs to learn from and implement Paul Volcker's recommendations to prevent this style of economic crisis in Australia in the future.

<u>What would implementing Paul Volcker's recommendations in Australia mean in practice?</u>

Let me summarise Paul Volcker's recommendations:

- **"We are going to need a financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort. ..... it's going to be different from the financial system that has developed in the last 20 years.** *A primary characteristic of the system ought to be a strong, traditional, commercial banking-type system. ....***we ought to have some very large institutions** ..... ***whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit.*** *They ought to be the core of the credit and financial system.*
- **you do know by experience that these *big commercial banking institutions will be protected by the government*, de facto.** .... **The government will support these institutions, which in turn *<u>implies a closer supervision and regulation of those institutions</u>, a more effective regulation than we've had. ..... those institutions should not engage in highly risky entrepreneurial activity.*** That's not their job because it brings into question the stability of the institution. They may make a lot of money and they may have a lot of fun, in the short run. It may encourage pursuit of a profit in the short run. But it is not consistent with the stability that those institutions should be about. It's not consistent at all with avoiding conflict of interest. ***These institutions that have arisen in the United States and the UK that combine hedge funds, equity funds, large proprietary trading with commercial banks, have enormous conflicts of interest.*** And I think ***the conflicts of interest contribute to their instability. So I would say let's get rid of that.*** *Let's have big and small commercial banks and protect them – it's the service part of the financial system.*
- And ***then we have the other part, which I'll call the capital market system***, which by and large isn't directly dealing with customers. ***They're dealing with each other. They're trading. They're about hedge funds and equity funds.*** And they have a function in providing fluid markets and innovating and providing some flexibility, and I don't think they need to be so highly regulated. They're not at the core of the system, ***unless they get really big. If they get really big then you have to regulate them, too.*** But I don't think we need to have close regulation of every peewee hedge fund in the world."

So in summary:

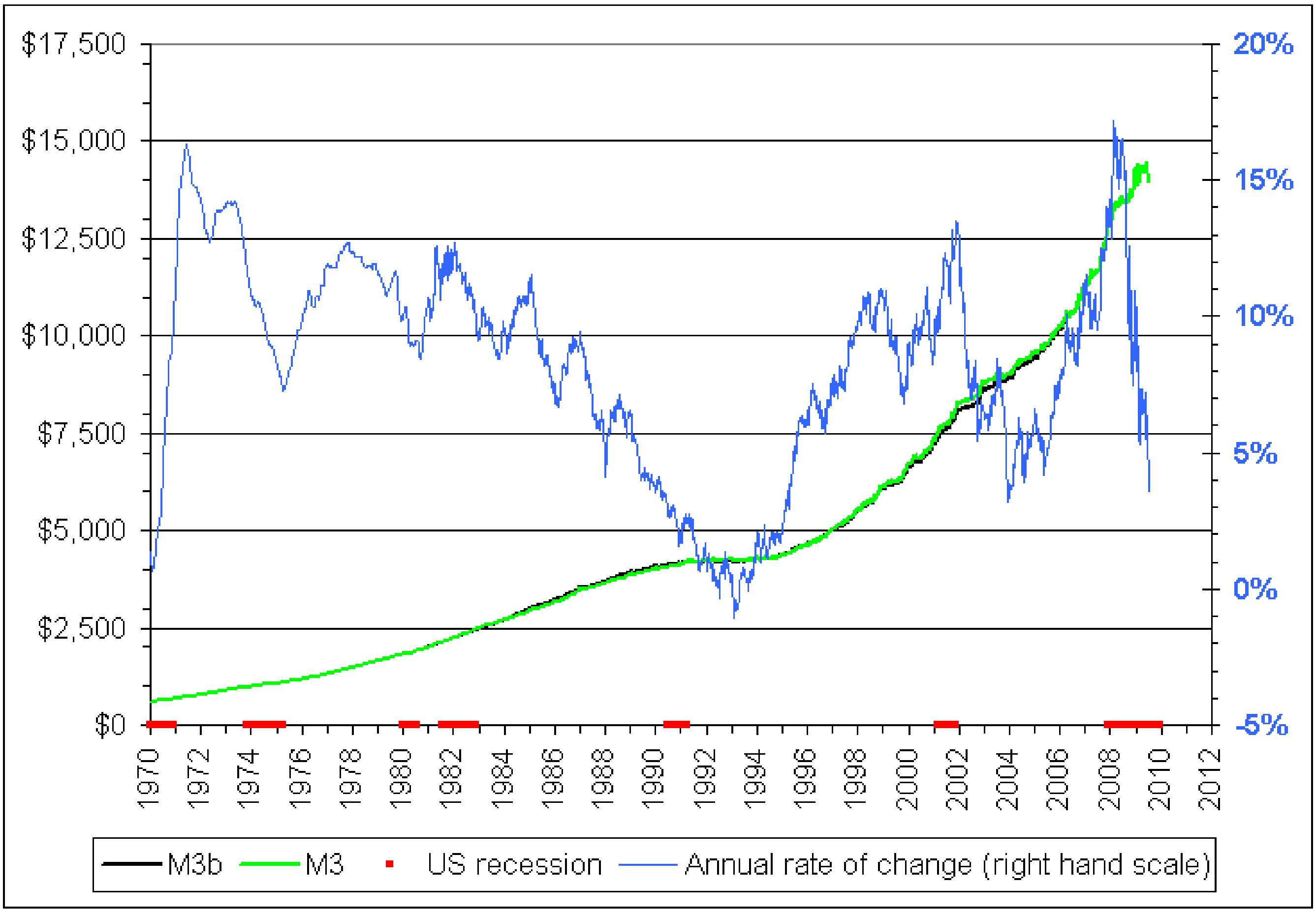
- The core of the Australian financial system needs to be build around ***commercial banks***:
  - which the government will protect,
  - whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by ***providing outlets for their money and by providing credit.*** They ought to be the core of the credit and financial system, and
  - that must be more closely supervised and regulated and those institutions should not engage in highly risky entrepreneurial activity.
- ***These commercial banks must divest themselves of highly risky entrepreneurial activities*** such as offering hedge funds, offering equity funds and proprietary trading. Largely these commercial banks would simply focus on deposit taking and providing credit.
- Then we have the ***capital market system.*** They're dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly

regulated. ***They're not at the core of the system, unless they get really big. (Too big to fail.) If they get really big then you have to regulate them, too.***

Applying Paul Volcker's key recommendations to Australian regulation would change the shape of financial institutions in Australia for the better. These changes would help create a "financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort." (Volcker):

- **<u>The commercial banks.</u>** The government to provide an explicit guarantee to Australian commercial banks – the core of the system. These commercial banks would simply focus on deposit taking and providing credit. These commercial banks must be more highly regulated. These commercial banks would need to divest all highly risky entrepreneurial activities including proprietary trading and wealth management.
- **<u>The capital market system.</u>** Capital market players are dealing with each other. They're trading. They're about hedge funds and equity funds. They don't need to be so highly regulated. They're not at the core of the system, <u>unless they get really big</u>. (eg Too big to fail.) If they get really big then you have to regulate tightly them, too.
- Since **<u>some Australian insurance companies are "too big to fail"</u>**, they would have to be regulated more tightly too.

- **<u>Recommendation 2: Ban securitisation of debt.</u>**
  http://en.wikipedia.org/wiki/Securitisation Problems with securitisation:
  - Securitisation became rampant in the mid 1990s and was central to the creation of the US$3trillion sub-prime debt problem, an important element of the global financial crisis.
  - One part of the problem with securitisation of debt is the loan originator does not retain the loan on it's balance sheet and therefore can become careless about the quality of loans that it makes. This contributed to the creation of the sub-prime debt problem.
  - However, the biggest problem with securitisation is that it removed a critical tool from the tool-box of central banks. Historically, one tools central banks have been able to control the money supply with has been by imposing reserving requirements on banks. By doing this, central banks could control the **Money Mutiplier** (see http://en.wikipedia.org/wiki/Money_creation#Money_multiplier) which controlled how much money could be created through the banking system. However, **with securitisation, the lending institutions could get a new loan off their balance sheets and hence the Money Multiplier in effect became infinity. This tool to control of the money supply needs to be restored to central banks – by banning securitisation of debt.**



Source: http://www.nowandfutures.com/

As you can see in the chart above, US money supply growth really accelerated rapidly during the mid 1990s and I believe securitisation was an important causal factor. In turn acceleration of growth of money supply was an important ingredient in share market and property bubbles over the last 15 years – and as such is a major contributing factor to the global financial crisis.

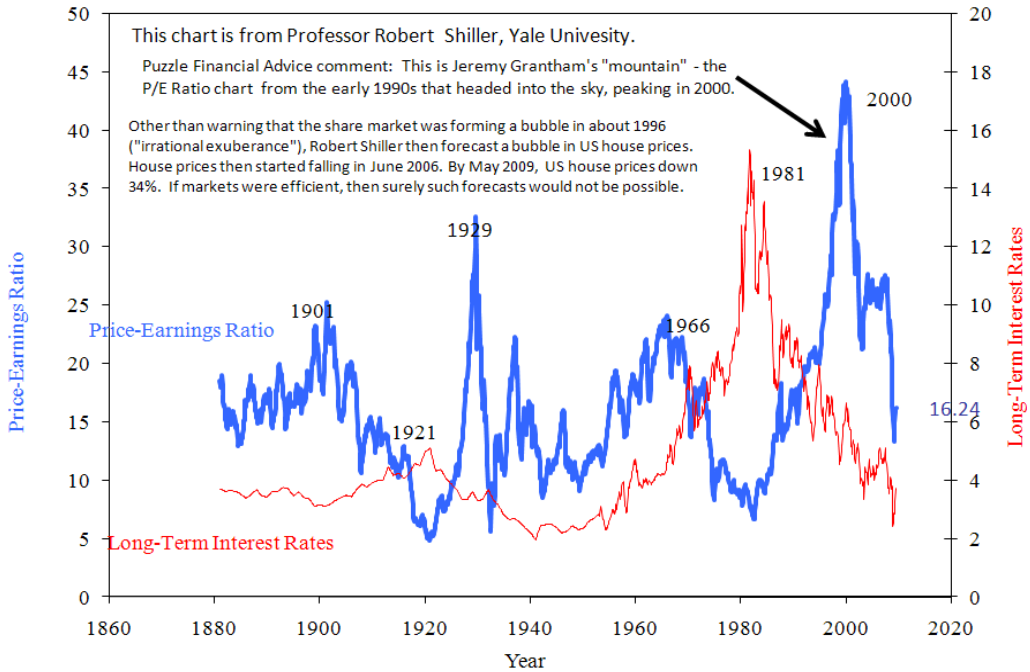
<u>Note:</u> Ideally, over the medium-term Money Supply needs to grow at approximately the same rate as the GDP. Over the last 15 years, Money Supply has grown much faster than that.

<u>3.1 Grantham argues that even Greenspan knew there should be a limit to market fundamentalism – but that Greenspan did not have the courage or the ethics to follow through on his convictions.</u>

Grantham "Feet of Clay. Alan Greenspan's Contribution to the Great American Equity Bubble" 10/2002.

- This document is attached.

○ "the underlying **job of the Fed probably is**, and certainly should be, **the maintenance of general economic stability.**
Nothing threatens economic stability more than the deflating of a major stock market bubble, particularly this time when there was a chance of global deflations even before the bubble broke. **This severe risk brushes aside the argument that bubbles are hard to detect, for the stakes are just too high not to try; great bubbles are, in any case, like <u>mountains</u> sticking out of the plain of normal stock prices.** Comparing 36 times earnings



to a previous 1929 high of 21 and a 75-year average of 14 times would not seem to take particularly sharp analytical skills. The potential dangers overwhelm Greenspan's defense that the techniques to resist bubbles are not certain, for what in economics is certain? **The stability of the US economy can only be protected against the real dangers of a bubble breaking by the Fed and its Chairman being willing, at rare intervals, to take some substantial political risks**. They must attempt to identify and moderate major stock bubbles and be prepared to bear some consequences. **If they are not prepared to do this, then the risk level of the economy will rise substantially.**
<u>Setting the Scene</u>
Major stock market bubbles are indeed about the most dangerous thing that can happen to an economy. They cause wasteful over investment in hot areas. Through the vast paper wealth they create, they substantially increase the amount of greed that is in any case in plentiful supply in a vigorous capitalist system. This in turn increases corruption a little and unethical behavior a lot. **Bubbles also redistribute wealth."**

○ "of course belated ***politicians, who had done little proactively, will jump to correct or over correct the problems***. The downside of the great bull markets will in fact always prove to be a paradise for Murphy's Law: whatever can go wrong will pick this time to do it. The over investment caused by excessive stock prices and excessive lending will be followed by a capital spending bust. ***An investing public who feels to some extent betrayed will lose confidence in investing.***"

- “**When he was not the one dodging bullets, Greenspan himself had a very different view as to the responsibilities of the Federal Reserve and what it could achieve.** ***In 1966 he had written scathingly of the consequences of weak-kneed behavior by the Fed in 1928 and the dire consequences of delayed and weak action for everyone in the ensuing crash.*** He wrote in his chapter in Ayn Rand’s Capitalism: The Unknown Ideal: *'When business in the United States underwent a mild contraction in 1927, the Federal Reserve created more paper reserves in the hope of forestalling any possible bank reserve shortage. The excess credit which the Fed pumped into the economy spilled over into the stock market - triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in breaking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed...'* **He is clearly blaming the Fed for both the boom and the resulting crash.**

  J.K. Galbraith, with presumably no axe to grind, having studied the last great equity bubble of the late twenties for his book **The Great Crash (John Kenneth Galbraith, The Great Crash**, 1929, pp. 189-194, New York, Mariner, 1997), ***concluded his analysis with a resounding vote that the Federal Reserve did indeed have the tools to prevent a major bubble but argued presciently it seems that such tools would never be used!*** He argued '**that the chance for recurrence of a speculative orgy** (like that leading up to 1929) **remains good.** No one can doubt that the American people remain susceptible to the speculative mood … **The government preventatives and controls are ready. In the hands of a determined government their efficacy cannot be doubted.** ***There are, however, a hundred reasons why a government will determine not to use them*** … **Action to break up a boom must always be weighed against the chance that it will cause unemployment at a politically inopportune moment.** ***It will always look, as it did to the frightened men on the Federal Reserve Board in February 1929, like a decision in favor of immediate as against ultimate death. As we have seen, the immediate death not only has the disadvantage of being immediate but of identifying the executioner*** … One might expect that … The Federal Reserve would be asked by bankers and brokers to lift margins to the limit … The public would be warned sharply and often of the risks inherent in buying stocks for the rise … all this might logically be expected. **However, it did not happen in the go-go years of the late sixties … nor will it ever come to pass** … ***Long-run salvation by men of business has never been highly regarded if it means disturbance of orderly life and convenience in the present. So inaction will be advocated in the present even though it means deep trouble in the future … It is what causes men who know that things are going quite wrong to say that things are fundamentally sound.”*** **This unfortunately for everyone sounds all too like the present Fed Reserve Boss.**

  Greenspan himself back in 1996, when the market at under half its final price was already irrational in his eyes, lets on that a bubble can indeed be broken. Paul Krugman recently pointed out ***Greenspan’s remarkable September 1996 statement to fellow Open Market Committee colleagues, 'I recognize that there is a stock market bubble problem at this point. We do have the possibility of increasing margin requirements. I guarantee that if you want to get rid of the bubble, whatever it is, that will do it.'*** This is only one of several smoking guns.

  Why did Greenspan not follow through after 'irrational exuberance?' Galbraith probably had it nailed. No one wants to be the one caught 'holding the pin.' No one looks forward to taking a lot of political heat and we know that Greenspan took a good deal because of 'irrational exuberance.'"

- What Was in His Head?

  Greenspan's vacillation and change of heart may have involved some woolly thinking, although **it is hard to separate woolly thinking from a tendency to change arguments to fit the politically convenient position.** There are two prime examples. First, **his view of market efficiency**. His **1966 view is that excesses or bubbles do indeed exist and can be identified and acted on**. After ***having his head slapped by congressmen for his 'irrational exuberance' miscalculation, he hurriedly moves to cover his tail by adopting a view that the market is efficient: 'to spot a bubble in advance requires a judgment that hundreds of thousands of investors have it all wrong.' Yet his suspicions in his earlier 1996 statement did sound like flat-out belief in an inefficient market.*** Now **in the summer of 2002 he returns to his earlier view: 'history attests, investors too often exaggerate the extent of the improvement in economic fundamentals. Human psychology being what it is, bubbles tend to feed on themselves and booms in later stages are often supported by implausible projections of potential demand.' 'Implausible projections!'** ***Here he sounds like a behavioralist who believes the market is a dangerous jungle of psychological impulse!*****"**

- Summary

  In the end, what Greenspan faced was not a moral dilemma. The morality was clear. He had the knowledge, experience, and belief and failed to act. What he had was a career dilemma. If he jumped off the moving bus early, he would have taken some considerable grief. If the economy had slowed, he would have been blamed. ***The timing of occasional ordinary recessions is not of vital importance to society. Indeed, an occasional moderate recession may be necessary for a healthy economy in the long run, although you could find economists who would argue the other side.*** The real cost to society comes from the corruption, disappointments, reduced savings, and the wasted investments brought on by a bubble. **The timing of recessions is, however, of real importance to politicians** who want to be re-elected and who face an electorate whose view of their political platforms is often a simple, 'It's the Economy, Stupid!' **In Greenspan's defense, we can agree he would have received little or no thanks for preventing the evils of a boom and bust for it could never be proved.** ***What we do know is the world's willingness to believe that things would work out well despite the bubble.*** So if he had acted, his reputation and career would have suffered at least temporarily. If he had engaged in wishful thinking, he could believe that there would be either a chance that things would muddle through or a chance that his denials of responsibility, muddled and contradictory as they are, would suffice. ***For a Federal Reserve boss to have volunteered to have taken a lot of political heat and certain short-term damage to his reputation without a realistic hope of offsetting rewards simply because it was the right thing to do would have taken very high ethical standards and considerable strength of character. Paul Volcker perhaps might have made that choice.***

  As for Greenpan's recent defense, in the end what did we expect? That he would repent his lack of character? That he would admit even partial fault? His complete denial on this regard brings to mind an incident in the Profumo sex scandal of the 1960s in England. One of the women involved, Mandy Rice Davis, on hearing that the government minister had denied having sex with her, replied with the immortal words, 'Well he would say that, wouldn't he?' Sometimes the blindingly obvious is funny. This time the equally predictable denial of responsibility and the apparent credulousness of many opinion makers (but encouragingly not all of them) in accepting his argument are merely irritating. Irritating or not, it must be conceded that in terms of avoiding blame he appears to have mostly gotten away with it. You can indeed 'fool most of the people all of the time.' 'Most of the people' this time probably included Her Majesty who recently knighted him for his global services. My secret hope though is that she justified it by having had a good short position for the last

3 years."

- *Note: Through the same period where Greenspan has been implementing policies he knew to be wrong, because he was not prepared to accept the consequences of the alternative, financial planners and fund managers were also facing the same dilemma. Yes, I expect some of them were unaware of the risks – some through ignorance or incompetence and some because of the conflicts of interests "blinded" them to risks which might require actions against their own interests. (rose-coloured glasses). Some fund managers and financial planners were aware of the risks but chose to ignore those risks for the same reason that Greenspan rationalised implementing the wrong policies. Some fund managers and financial planners saw the risks, and acted in the best interest of their clients.*
  - *Note: Acting against the interests of your client, because you are not prepared to accept the consequences of the alternative – related to a concept in funds management and financial planning known as "**career risk**".*
- *Note: It never makes sense for long-term investors to invest in a bubble. Obviously, index investing has you investing in a bubble. **Promoters of long-term buy-and-hold have to believe that you cannot recognise a speculative bubble, if you are to promote long-term buy-and-hold index investments.***

3.2 Greenspan Concedes to `Flaw' in His Market Ideology (Update3)

http://www.bloomberg.com/apps/news?pid=20601087&sid=an8vy29bsXk8&refer=home

By Steve Matthews and Scott Lanman

Oct. 23 2008 (Bloomberg) -- Former Federal Reserve Chairman Alan Greenspan said a ``once-in-a-century credit tsunami'' has engulfed financial markets and conceded that his free-market ideology shunning regulation was flawed.

``Yes, I found a flaw,'' Greenspan said in response to grilling from the House Committee on Oversight and Government Reform. ``That is precisely the reason I was shocked because I'd been going for 40 years or more with very considerable evidence that it was working exceptionally well.''

Greenspan acknowledged he was ``partially'' wrong for opposing the regulation of derivatives over the years. A former Fed chairman normally afforded deference by Congress endured almost four hours of questions from lawmakers seeking a scapegoat for the financial crisis less than two weeks before a national election.

``We have to do our best but not expect infallibility or omniscience,'' he responded under questioning. Part of the problem was that the Fed's ability to forecast the economy's trajectory is an inexact science, he said.

``If we are right 60 percent of the time in forecasting, we are doing exceptionally well; that means we are wrong 40 percent of the time,'' Greenspan said. ``Forecasting never gets to the point where it is 100 percent accurate.''

The admission that free markets have their faults was a shift for the former Fed chairman who declared in a May 2005 speech that ``private regulation generally has proved far better at constraining excessive risk-taking than has government regulation.''

`Paying the Price'

Committee Chairman Henry Waxman, a California Democrat, said today that Greenspan had ``the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis.''

``You were advised to do so by many others,'' he told the man hailed in the 1990s as the ``Maestro'' of the global financial system and awarded a knighthood in 2002. ``And now our whole economy is paying the price.''

Greenspan's devotion to free markets was nurtured in part by his association with Ayn Rand, the libertarian novelist and philosopher who espoused laissez-faire capitalism. He met Rand in the 1950s, becoming part of her inner circle of followers meeting regularly in her Manhattan apartment.

``Greenspan in a very, very kind of unwise, left-brain way, imputed pure rationality to markets,'' said James Grant, editor of Grant's Interest Rate Observer. ``They are just as rational and just as efficient as the people that operated in them.''

Waxman echoed that sentiment to Greenspan: **``The mantra became government regulation is wrong. The market is infallible.''**

Gramlich's Warnings

Former Fed Governor Edward Gramlich, who died in 2007, had urged Greenspan to strengthen oversight of banks during the record U.S. mortgage boom from 2004 to 2006.

Questioned about those warnings, Greenspan said ``Governor Gramlich said to me that he had problems'' and that he left the meeting expecting a Fed subcommittee dealing with consumer and community affairs to present recommendations, which didn't occur. ``I presumed at the time that essentially the subcommittee didn't think it rose to the higher level'' requiring action, Greenspan said.

Responding to criticism that he was too ideological, Greenspan said he sought as chairman to abide by laws passed by Congress, ``not my own predilections.''

He later added that he couldn't respond to every warning. ``There are always a lot of people raising issues, and half the time they're wrong.''

Regulatory Actions

Greenspan pointed out that he voted for every regulatory action the Fed moved on, drawing a rebuke from Waxman. ``On the other hand, you didn't get to vote on regulations that you didn't put before the Federal Reserve board, even though you had the legal authority for those regulations.''

Firms that bundle loans into securities for sale should be required to keep part of those securities, Greenspan said in prepared testimony. Other rules should address fraud and settlement of trades, he said.

Greenspan opposed increasing financial supervision as Fed chairman from August 1987 to January 2006. Policy makers are now struggling to contain a financial crisis marked by record foreclosures, falling asset prices and almost $660 billion in writedowns and losses tied to U.S. subprime mortgages.

Greenspan, 82, reiterated his ``shocked disbelief'' that financial companies failed to execute sufficient ``surveillance'' on their trading counterparties to prevent surging losses. The ``breakdown'' was clearest in the market where securities firms packaged home mortgages into debt sold on to other investors, he said.

Pricing Risk

``In this financial environment, I see no choice but to require that all securitizers retain a meaningful part of the securities they issue,'' Greenspan said. That would give the companies an incentive to ensure the assets are properly priced for their risk, advocates say.

Greenspan said the Fed didn't know the size of the subprime mortgage market until late 2005.

Securities and Exchange Commission Chairman Christopher Cox and former Treasury Secretary John Snow also appeared at the House committee hearing.

`Bad, Bad Path'

Snow said the economy is headed down a ``bad, bad path'' and he endorsed consideration of more fiscal stimulus. For the longer term, **Snow said the global financial system should be reorganized by focusing on increasing transparency of ``excessive'' leverage to prevent institutions from creating too much risk.**

The U.S. needs ``one strong national regulator'' to oversee firms and fix what Snow called ``a fragmented approach'' to regulation.

Addressing the trio that oversaw the U.S. financial markets as the housing bubble developed, Representative John Yarmuth, a Democrat from Kentucky, characterized them as ``three Bill Buckners,'' referring to the Boston Red Sox first baseman whose fielding error some fans blame for the team's loss in the 1986 World Series.

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Last Updated: October 23, 2008 15:55 EDT

3.3 Kevin Rudd "fundamentalist ideology of self-regulating markets has imploded".

http://www.smh.com.au/national/pain-on-the-road-to-recovery-20090724-dw6q.html?page=-1
Kevin Rudd's essay "Pain on Road to Recovery" in the Sydney Morning Herald 25th July 2009.

> "As I have argued elsewhere, the boom-and-bust economic cycle of the past decade has been an unavoidable consequence of a decade of neo-liberal free market fundamentalism that reinforced a culture of corporate greed and excess in the financial sector. ***The central principles of this extreme form of capitalism are that markets are self-regulating; that government should get out of the road of the market altogether and that the state itself should retreat to its core historical function of security at home and abroad.***
>
> ***This fundamentalist ideology of self-regulating markets has imploded comprehensively with the current crisis.*** We have seen spectacular market failure requiring equally spectacular government intervention in the economy to effectively save the system from itself."

4. Efficient Market Hypothesis (EMH). The EMH is flawed.

- If markets were efficient, the there would be no stock-pickers like George Soros, Kerr Neilson and Warren Buffett who, over decades, have added value by picking stocks - delivering better than market average performances.
  - This is not to say that the average active manager delivers value for money – as I believe that they do not – but this is for other reasons eg index-hugging and not competing on performance or product but by competing on distribution channels.
  - Yes, from time to time a fund manager might outperform over a significant period of time – but there are some who do it through stock-picking skill etc.
- Let us start with a summary of efficient market hypothesis (EMH). A reasonable summary of the EMH can be found at http://en.wikipedia.org/wiki/Efficient_market_hypothesis#cite_note-0
  - "**The efficient-market hypothesis was developed by Professor Eugene Fama** at the University of Chicago Booth School of Business as an academic concept of study through his published Ph.D. thesis in the early 1960s at the same school. It was widely accepted up until the 1990s."
  - "**Investors and researchers have disputed the efficient-market hypothesis** both empirically and theoretically."
    - "**Behavioral economists** attribute the imperfections in financial markets to a combination of cognitive biases such as overconfidence, overreaction, representative bias, information bias, an inability to use configural rather than linear reasoning, and various other predictable human errors in reasoning and information processing."
    - "Empirical evidence has been mixed, but has generally not supported strong forms of the efficient markets hypothesis. According to Dreman, in a 1995 paper, low P/E stocks have greater returns. In an earlier paper he also refuted the assertion by Ray Ball that these **higher returns could be attributed to higher beta**, whose research had been accepted by efficient market theorists as explaining the anomaly in neat accordance with modern portfolio theory." Note: **Beta is a concept in the efficient market theory – that Eugene Fama's & Kenneth French's long-term historical in the early 1990 showed was not supported by the long-term historical data. Fama & French proposed the three-factor model in the place of beta.**
    - **"**One can identify "losers" as stocks that have had poor returns over some number of past years. "Winners" would be those stocks that had high returns over a similar period. **The main result of one such study is that losers have much higher average returns than winners over the following period of the same number of years. ....** The study showed that the beta difference required to save the EMH is just not there.**"**
    - **"Speculative economic bubbles** are an obvious anomaly, in that the market often appears to be driven by buyers operating on irrational exuberance, who take little notice of underlying value**."**
    - **"Behavioral psychology a**pproaches to stock market trading are among some of the more promising alternatives to EMH**"**

- **Jeremy Grantham, chairman GMO. www.gmo.com** "***When you believe in market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving. It's ruinously expensive."***
  http://www.smartmoney.com/investing/economy/Why-Jeremy-Grantham-Changed-his-Mind/?page=all
  - **SmartMoney: That's the future. But why did so many supposedly smart people miss this disaster over the past two years?**

Jeremy Grantham: The ultimate villain of this is the belief in rational expectations—that the market tends to be efficient. People who have anything to do with investing either believe it a bit or believe it a lot. There are only a few of us ornery disbelievers who don't believe that the market is efficient at all.
SmartMoney: What's wrong with believing that the market is efficient?

Jeremy Grantham: If you believe in it, then you don't see asset bubbles. And there's nothing as dangerous as an asset bubble. If you even slightly believe in it, you believe in [former Federal Reserve Chairman] Alan Greenspan's idea that markets can control themselves. You believe that you should buy and hold the market. You believe you should have a fixed asset mix and you should never change it, because why would you? The market is efficient! ***When you believe in market efficiency, it's like being on the railroad watching the locomotive coming toward you. Then you just stand your ground just for the discipline of not moving. It's ruinously expensive.***

- **Bill Gross**, MD Pimco "**The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking.**" Pimco is the world's largest bond manager. www.pimco.com http://media.pimco-global.com/pdfs/pdf/IO%20July%2009%20WEB.pdf?WT.cg_n=PIMCO-US&WT.ti=IO%20July%2009%20WEB.pdf
  - "**Forecasts based on econometric models inevitably miss these secular/structural breaks in historical patterns** because it is impossible to quantify human behavior, and long-term trends involving risk-taking and in turn derisking are decidedly human in their origin. **Bell-shaped curves with Gaussian/random distributions fail to anticipate that human beings do not make decisions by chance or independently of each other, but in many cases in reaction to one another**. Humanity's personal and social computers appear to be programmed that way. And so, instead of 'normal' distributions, **economists and investors must learn to be on the lookout for 'black swans,' and if not, then certainly 'fat tails,'** which differ from the measurement of natural phenomena accepted in science. 'New normals,' flatter-shaped bell curves, and structural shifts in previously accepted standards become not only possible, but probable as human nature reacts to itself and its prior behavior. ***The efficient market hypothesis was always dead from the get-go, but academic tenure and Nobel prizes were food for the unwilling or perhaps unthinking.*** PIMCO and yours truly are not masters of the antithesis, a subjective approach which might derisively be called 'crystal ball gazing,' but **we try to focus on what might be legitimate changes in the way economies and financial markets are affected by seemingly irrational or 'non-normal' behavior and events.** The ***supersizing of financial leverage and consumer spending in concert with the politicizing of deregulation*** *describes* in fifteen words ***our most recent brush with irrational behavior and inefficient markets.*** Greed will come again. But for now, the trend is the other way and ***it promises to persist for a generation at a minimum***. The fact is that American consumers have suffered a collapse in wealth of at least $15 trillion since early 2007. Global estimates are less reliable, but certainly in multiples of that figure. And **when potential spenders feel less rich by that much, the only model one can use to forecast the future is a commonsensical one that predicts higher savings, lower consumption, and an economic growth rate that staggers forward at a new normal closer to 2 as opposed to 3½%. There's no magic in that number, and no model to back it up, just a lot of commonsense** that says this is how people and economic societies behave when stressed and stretched to a near breaking point."

- **Central banks using flawed models. Regulators need to review market assumptions.** Australian Financial Review 25/7/09 "Old economics under fire". (Attached)
  - "Mainstream economic models were deeply flawed."
  - "'I find it surprising that central banks populated with rational men have thought using these models would keep the economy stable.'"
  - "macro-economics were blinded by the idea that efficient markets would take care of themselves."
  - "Sunstein's views and those of many like him have **big implications for all those who oversee** and take part in **markets**."

- Professor Lo of MIT – EMH remained influential because of 'physics' envy.'

http://www.ft.com/cms/s/0/cf6d096a-6d7a-11de-8b19-00144feabdc0.html?nclick_check=1

See Appendix C. In "What can replace efficient markets theory?" by Jonathan Davis July 12 2009, Johnathan reports

"The most interesting thing about the e**fficient markets hypothesis** is not whether it is valid or not – clearly it is not – but how it has managed to remain so influential for so long. At a recent conference in London on the subject, organised by the CFA Institute, Professor Andrew Lo of Massachusetts Institute of Technology offered the audience a simple explanation: 'physics envy'.

This was a reference back to the early inspiration of the Nobel economics laureate Paul Samuelson, who set out to find for economics a set of fundamental laws that would do for the dismal science what Newton's laws of thermodynamics had done for physics, and from which a rigorous general theory with practical uses could subsequently be developed. "

"The attempt to bring order and an overarching theoretical framework into analysis of the seemingly unruly behaviour of financial markets was a temptation that has for years proved too great for academics (and many market participants) to resist, but it has turned out to be a long and largely fruitless journey."

"Behavioural finance has grown to become a popular alternative approach precisely because it does appear to explain more clearly how investors, individually and collectively, appear to act.

In Prof Lo's words: 'Economic systems involve human interactions, which almost by definition are more complex than interactions of inanimate objects governed by fixed and known laws of motion.'

The real beauty of the efficient markets hypothesis, and the explanation for its longevity in the face of consistent empirical evidence that it is invalid, surely lies in its beguiling simplicity.

As the future is uncertain and many of the key variables that concern investors cannot be predicted with confidence, a theoretical structure that appears to offer a way to live with uncomfortable reality has obvious attractions."

"Most important of all, investors cannot rely on the comforting message of the efficient market hypothesis that all you need to do to obtain an expected return is to take the appropriate level of risk.

The ***biggest problem with this new approach, as with all alternatives to EMH, including behavioural finance, is that it doesn't give investors a simple metric for understanding what to do. Its great merit, however, is that it appears to relate to the complex and uncertain world that we all actually inhabit, something the efficient markets hypothesis has never done."***

- **"Myth of the Rational Market - A History of Risk, Reward, and Delusion on Wall Street "**

  http://www.washingtonpost.com/wp-dyn/content/article/2009/06/05/AR2009060502053.html

"On Wall Street, the Price isn't right" discussing a book called **"The Myth of the Rational Market -** ***A History of Risk, Reward, and Delusion on Wall Street*** **"** 7/June 2009.

"The upside of the current Great Recession is that it could drive a stake through the heart of the academic nostrum known as the ***efficient-market hypothesis***. This theory holds that stock and bond markets are nearly perfect -- even during such crazes as the dot-com mania -- and that prices on the exchanges instantly and accurately reflect the available information about publicly traded securities. ***After the market crash of 1987, Yale University economist Robert Shiller called that belief 'the most remarkable error in the history of economic theory.' He could have said 'most harmful error' as well.*** Yet it lived on and contributed mightily to the mortgage bust."

"How did this faith in the supremacy of market group-think do us harm? For one, as the dot-com and other manias demonstrated, the crowd occasionally gets it wrong. The mistaken faith in markets turned regulators into fawning groupies. Notably, former Fed chairman Alan Greenspan doubted that he or anyone else could detect -- or regulate -- a bubble in advance."

"Fox tells the story of how financial engineers assumed that markets would behave the same way, with generally predictable variances in prices. ***In particular, the theory of option pricing, the cornerstone of modern finance, has built into it the assumption that prices are random. The theory was devised by Fischer Black, Myron Scholes and Robert Merton. The last two won the Nobel Prize in 1997 and***

were partners in Long-Term Capital Management, the hedge fund that blew up in 1998. What happened to LTCM? It turned out that in financial markets, extreme events do happen. People get emotional and decide to buy (or sell) in unison. All of LTCM's trades went sour simultaneously. Nonetheless, the modelers kept at it. Rating agencies assumed that subprime mortgagees would behave in random fashion -- large numbers of people would never default at the same time, right? (Oops.)"
"Fox recognizes that true believers in the market's efficiency suffered from a "blinkered" mindset and 'tunnel vision.' Yet I think he lets them off too easily. He laments (as if it were necessary) the lack of any alternative 'grand new theory' and finds that the debate has resulted in a 'muddle.' Fox concludes, 'If you do come up with an idea for beating the market, you need a model that explains why everybody else isn't already doing the same thing.' Not necessarily. ***Markets aren't physics. Maybe no one model explains them.***
The emerging school of behavioral finance fills in many of the gaps left by the efficient marketers. Behavioral finance, which Fox discusses at length, holds that financial man -- far from the perfect, mechanical trader depicted in textbooks -- is a rather neurotic fellow. He follows the crowd, fails to plan ahead and often makes mistakes. To think that his every price is perfect is a remarkable error indeed. "

In summary:

- Many leading thinkers in investment markets & economics believe that the Efficient Market Theory is fatally flawed. As you can see from above, Jeremy Grantham goes as far as to say that it can be very dangerous for investors to believe in market efficiency because "it's like being on the railroad watching the locomotive coming toward you." This is precisely the way many investors have behaved over the last 2 years through this global financial crisis – to their detriment.
- Even Eugene Fama, the father of efficient market theory, has moved on from his thinking in the 1960s. Fama & French is the early 1990s came up with the Three Factor model which better explains the actual behaviour of investment markets. And Fama can see potential for other factors to help explain the actual behaviour of markets eg momentum.
- Behavioural finance is a major emerging framework that clearly can be seen to operate in markets. Markets aren't physics. Maybe no one model explains them.
- Yes, we can see efficient market effects at work in markets. We can also see behaviourial effects in markets. Despite this ASIC seems to be strong promoting/advocating "vanilla" investment advice – based on the flawed assumption that the Efficient Market Theory and the Capital Asset Pricing Model are robust and can be relied on. This is likely to produce a suboptimal outcome for consumers.

  Recommendation 3: A better solution for consumers would be if we created a **Financial Planner Registration Board** (with a panel of expert independent [i.e. not conflicted] practicing financial planners) which would determine what acceptable advice was – and that this definition of "acceptable" advice could evolve as investment theory evolves – as it continually will evolve. This Financial Planner Registration Board would also help consumer's avoid losses as has occurred with Storm Financial and Westpoint. The Financial Registration Board would have the following features:
  - designed by accounting professional bodies and BFPPG with ASIC input.
  - Not compulsory. Many current financial planners would not qualify.
  - Higher education and an obligation to act in best interests of the client.
  - product manufacturer-owned planners can be registered but have no say in the FPRB because it is critical that the FPRB stay outside the control or influence of product manufacturers and their distribution arms.
  - The FPRB to have a panel of professional independent advisors who will form views of what is acceptable advice, what is high risk advice and what is unacceptable advice.
  - FPRB would define what is "acceptable" advice and this would evolve as investment theory evolves.

- A discussion paper on how the FPRB might work is attached.

A vision for future of financial planning advice in Australia

Quality advice, choice in style and price

Independent advice

Higher education standards + **Financial Planner Registration Board** keeps quality of advice high

Professional Standards – include fiduciary responsibility including obligation to act in best interests of client.

Product distribution channels – salespeople.

Vanilla expensive advice.

* AFSL to take total responsibility for all advice unlike now.

* AFSL takes a very close supervisory role on reps

Super Funds providing intra-product advice.

Standardised vanilla inexpensive advice

Already have obligation to act in best interests of client

5. Fama 11/2007 Three factor model replaces Capital Asset Pricing Model. Sees potential for further evolution of theory.

Interview of Eugene Fama 11/2007 including his current view on efficiency of markets.

http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=1134

The full interview is also to be found in the appendices.

EFFICIENT MARKET THEORY

Region: Can you give us a lay definition of the efficient market hypothesis? How does it differ from random walk [the idea that movements in stock prices are unpredictable]? And what is the genesis of efficient market theory?

Fama: The basic wording of it is very simple. It says prices reflect all available information. The conundrum is how to determine whether prices reflect all available information, and you can't do that without a model of market equilibrium. What I added to the story was just pointing out that you need a model of market equilibrium in order to carry out the tests of market efficiency.

In the early 1960s, the advent of computers allowed people to do things with data that they couldn't do before. And the most easily available data was stock market data. So lots of people started working on stock market returns, and the question arose, well, what would we expect if markets were working properly? *"Random walk" was the first manifestation* of that. *But* it's kind of a clumsy statement because *it doesn't recognize that you need a model of market equilibrium to decide what the market's trying to do in setting prices.*

Region: So *that is the "joint hypothesis."*

Fama: Right. The *joint hypothesis problem says that you can't test market efficiency without a model of market equilibrium. But the reverse is also true. You can't test models of market equilibrium without market efficiency because most models of market equilibrium start with the presumption that markets are efficient.* They start with a strong version of that hypothesis, that everybody has all relevant information. Tests of market efficiency are tests of some model of market equilibrium and vice versa. *The two are joined at the hip.*

Once I pointed that out, *it was clear that the random walk model was kind of irrelevant. You could have prices not following random walks because the model of market equilibrium could generate expected returns that had some predictable time-varying patterns to them.* So the whole nature of the game changed.

Region: The idea that things are unpredictable doesn't necessarily mean that they're efficient.

Fama: No, not necessarily. Sure, *prices could be random and still be inefficient.* Basically, *what market efficiency says is that the deviation of the realized price from the equilibrium expected value is unpredictable based on any past information.*

Region: Can you tell us about the genesis of this idea? You were at Tufts University at the time, I believe.

Fama: When I was at Tufts, I was working for a professor who had a stock market forecasting service. My job was to devise rules for predicting the market, and I was very good at it. But he was a pretty good statistician. He always told me to set some data aside so I could test [the rules] out of sample. And they never worked out of sample.*

So when I came to the University of Chicago and people were talking about these things, it suddenly dawned on me that maybe that was the nature of the game, that *there just wasn't much predictability of returns because markets were working efficiently.* That was the beginning of the story.

There were lots of people at Chicago and at MIT who were very interested in that issue. Merton Miller. Franco Modigliani. Paul Cootner. Paul Samuelson was very interested in it. And Benoît Mandelbrot.

Region: The subject of your first paper, I think.

Fama: Right. Half of my thesis was on the predictability of returns and the other half was on the nature of the return distribution, which was what Mandelbrot was all about, and still is.

IRRATIONAL EXURBERANCE

Region: Some economists—you know them well—say that the stock market crash of 1929 and the more recent climb and decline of the market in the early 2000s suggest that "irrational exuberance" affects the stock market. How do you reconcile this alleged evidence of herding behavior and animal spirits with the notion of market efficiency?

Fama: Well, economists are arrogant people. And because they can't explain something, it becomes irrational. The way I look at it, there were two crashes in the last century. One turned out to be too small. The '29 crash was too small; the market went down subsequently. The '87 crash turned out to be too big; the market went up afterwards. So you have two cases: One was an underreaction; the other was an overreaction. That's exactly what you'd expect if the market's efficient.

The word "bubble" drives me nuts. For example, people say "the Internet bubble." Well, if you go back to that time, most people were saying the Internet was going to revolutionize business, so companies that had a leg up on the Internet were going to become very successful.

I did a calculation. Microsoft was an example of a corporation that came from the previous revolution, the computer revolution. It was hugely profitable and successful. How many Microsofts would it have taken to justify the whole set of Internet valuations? I think I estimated it to be something like 1.4.

Region: About one and a half Bill Gateses.

Fama: That's right. And Microsoft was a good example because the worse their products were, the more money they made [laughter]. Who didn't struggle with DOS and then the first versions of Windows?

HAS FAMA SOFTENED?

Region: I was going to ask you about that. As you know, I'm sure, there was a lengthy *Wall Street Journal* profile of you and your colleague Richard Thaler in 2004, suggesting that you had softened a bit.

Fama: [Laughter].

Region: And I'm wondering if that was accurate or if you've always believed that markets are less than perfectly efficient?

Fama: I start my class every year by saying, "These are models. And the reason we call them models is that they're not 100 percent true. If they were, we would call them reality, not models. They're simplifications." But the acid test is, How good are the simplifications for your purposes? And for almost all purposes, market efficiency is a very good approximation. There is very little evidence that money managers can beat the market.

THREE-FACTOR MODEL

Region: ***With Kenneth French, you've said that the capital asset pricing model (CAPM) developed by John Lintner and William Sharpe has "fatal problems" in explaining stock market returns because of its reliance on beta*** [the volatility of an individual stock relative to overall market volatility]. And you've found that two other factors are crucial for determining prices. Can you tell us about these factors? Are they inefficiencies, or do they represent hidden risk? And is the CAPM truly dead?

Fama: ***Let me first tell you what the returns evidence says, and then we can talk about how to interpret it. The returns evidence basically says that if you look at the CAPM market beta, it's not enough to describe the cross section of average returns.***

The CAPM says that all you need to know are these market betas, market sensitivities, in order to fully describe the cross section of average returns. ***What you find is that other variables contribute to the explanation of average returns above and beyond what you get from beta. Indeed, over the last 50 years, you get very little at all from beta.***

The two variables that we've focused on are market capitalization (the financial profession calls it size, a misnomer because it's really market capitalization) and the book-to-market ratio, the ratio of the book value of a common equity to its market value. Now, there's no magic in that ratio. The ratio of almost anything to price will work as well. These are the two variables.

So, small-cap stocks have higher average returns than large-cap stocks, and stocks with higher ratios of book value to market value have higher returns than low book-to-market stocks. Low book-to-market stocks tend to be growth stocks. High book-to-market stocks tend to be relatively more distressed; they're what people call value stocks. That's given rise to what the finance profession—academic as well as applied—calls the size premium and the value premium. The value premium tends to be bigger. So the issue then is, Are these risk factors or market inefficiencies? One group of people says they're market inefficiencies—particularly the value premium. The behaviorists tend to say the value premium is a market inefficiency. Their story is: The market overreacts to good and bad past times. It doesn't understand that things tend to mean revert. ***So growth companies that have done very well tend to be overpriced, and value companies that have done poorly tend to be underpriced***, and then the market realizes this and corrects it. And this story says, basically, that people are dumb; they never learn. So every generation of growth stocks and value stocks goes through the same sort of cycle.

That's not too appealing to an economist—the idea that people never learn about these things—but that is the **behavioral story**. And initially they said these are arbitrage opportunities because if you go long value stocks and short growth stocks, you get something with a variance close to zero.

But French and I pointed out that if you do that, you get something with a variance very close to the market *variance*, not zero. It's quite a risky strategy. And the premium is about the size of the market premium. So it looks and smells like a risk premium. And we developed a three-factor model with a size premium in addition, basically the difference between the returns on small stocks and big stocks.

So, our model has three factors. Every asset pricing model says you need the market in there. Then they differ on how many other things you need. The CAPM says you only need the market. We basically say a minimum of two other factors seem to be necessary. And these two do a pretty good job.

There's still a *third* explanation, which is not based on overreaction. It says that people just don't like small stocks and value stocks. There's some amount of utility that people get from the nature of the stocks that they hold. So they like big stocks and they like growth stocks, and they're willing to hold them even though they have lower average returns.

Now you can't have an arbitrage opportunity there because then there'd be a sure profit. But the fact that they look like risk factors can sustain that story. You can't tell the difference between that story and a risk story.

MOMENTUM

Region: Let me ask you about momentum. ***You've said that it's the strongest challenge to the hypothesis of market efficiency.*** Can you elaborate on that?

Fama: ***There's evidence that if you rank stocks every month based on their last year of returns, the very extreme winners tend to win for a few more months and the losers tend to lose for a few more months.***

That seems to be true in U.S. data beginning around 1950. We don't have foreign data going back that far, but it tends to be there in major foreign markets except for Japan. It doesn't tend to be there in the U.S. data for the '30s and '40s. So there's some chance that it is just a chance result. There are so many people looking for anomalies in the data, that may just be the biggest one that they've found. Maybe it won't be there in the future. We don't know yet.

FINANCE/MACRO

Region: It seems to me that ***macroeconomists are paying more attention these days to the work of financial economists***, especially in trying to understand asset pricing. Do financial economists find equal value in the macro theory work being done these days?

Fama: *I think those two areas have always been pretty closely joined.* I, in fact, wrote a lot of macro-related stuff in the '80s or even earlier. For example, rational expectations stuff is basically efficient markets; they're pretty much the same thing. ***If you're talking about the macroeconomy, I don't see how you can avoid financial markets. That's a big part of the game.*** Nobody talks about money and bonds anymore the way they did when I was taking macroeconomics. Now people realize it is a lot more complicated. Finance and macro are joined. Our finance faculty has several people who were trained as macro-economists, especially on the asset pricing side.

Appendix A. ASIC's stated position on efficient market theory & the impact of this belief on ASIC's regulatory behaviour.

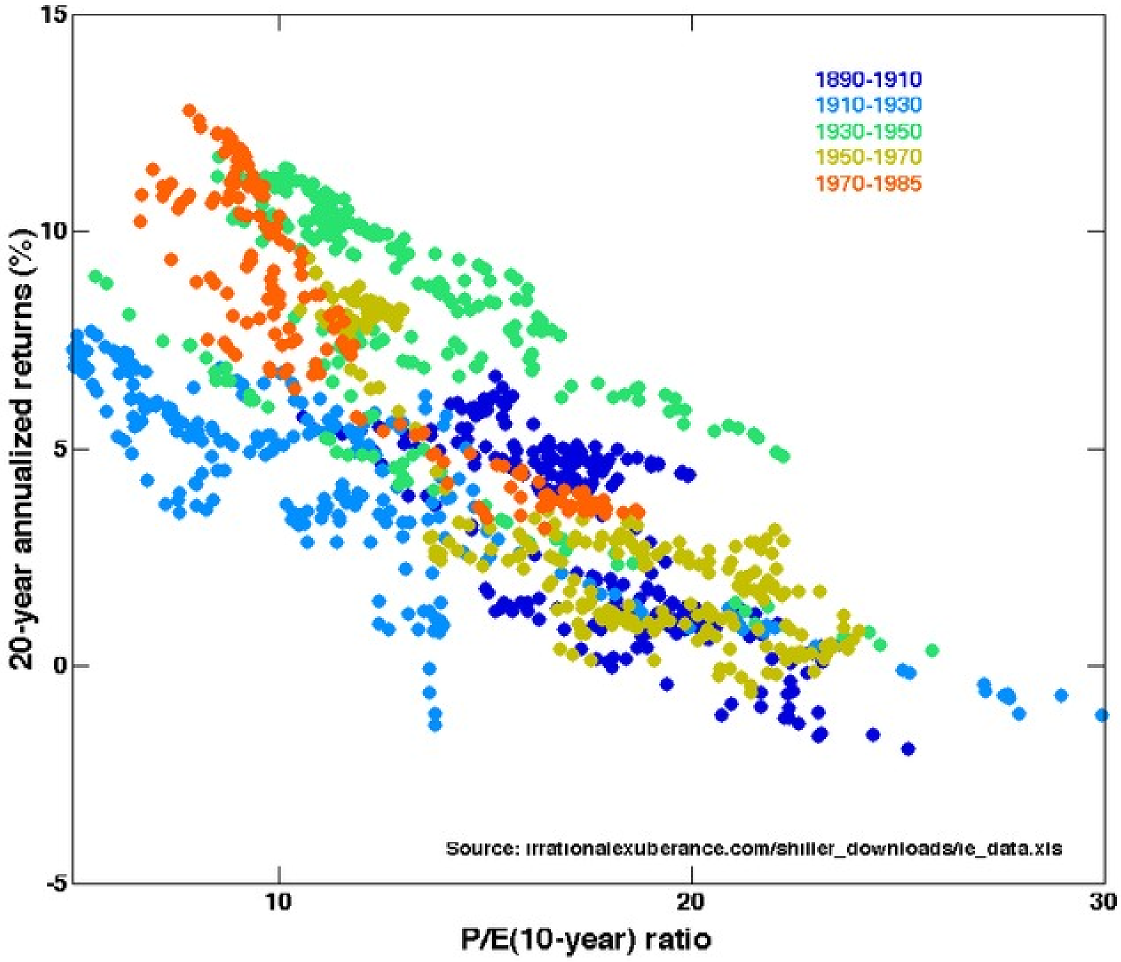
In the opening statements of the first public hearing in the PJC's Inquiry into Financial Services, ASIC said the following (http://www.aph.gov.au/hansard/joint/commttee/J11928.pdf):-

Mr Erskine—*I am going to address the general regulatory environmental and look at the underlying economic philosophy that lies behind the relevant part of the Corporations Act. That philosophy is that markets drive efficiency and that markets operate most efficiently when there is a minimum of regulatory intervention. So, in shorthand form, this might be termed the efficient market theory—being a quiet pragmatic reliance on financial markets driving efficiency and with intervention addressing market failures.* There is a body of economic and financial thought behind this, and I will not take you through all the ins and outs of the theory. There is: **Markowitz's** portfolio theory, (Eugene) **Fama's** efficient markets hypothesis, the capital asset pricing model, the **Black-Scholes** option pricing model, and **Modigliani** and **Miller's** advances in corporate finance theory. All of these focus on risk and return and build onto what we understand more generally about the behaviour of the economy.

Appendix B. Wikipedia - What is wrong with Efficient Market Theory?

http://en.wikipedia.org/wiki/Efficient_market_hypothesis#cite_note-0

Criticism and behavioral finance



Price-Earnings ratios as a predictor of twenty-year returns based upon the plot by Robert Shiller (Figure 10.1,[18] source). The horizontal axis shows the real price-earnings ratio of the S&P Composite Stock Price Index as computed in *Irrational Exuberance* (inflation adjusted price divided by the prior ten-year mean of inflation-adjusted earnings). The vertical axis shows the geometric average real annual return on investing in the S&P Composite Stock Price Index, reinvesting dividends, and selling twenty years later. Data from different twenty-year periods is color-coded as shown in the key. See also ten-year returns. Shiller states that this plot "confirms that long-term investors—investors who commit their money to an investment for ten full years—did do well when prices were low relative to earnings at the beginning of the ten years. Long-term investors would be well advised, individually, to lower their exposure to the stock market when it is high, as it has been recently, and get into the market when it is low."[18] **This correlation between price to earnings ratios and long-term returns is not explained by the efficient-market hypothesis.**

Investors and researchers have disputed the efficient-market hypothesis both empirically and theoretically. Behavioral economists attribute the imperfections in financial markets to a combination of cognitive biases such as overconfidence, overreaction, representative bias, information bias, an inability to use configural rather than linear reasoning, and various other predictable human errors in reasoning and information processing. These have been researched by psychologists such as Daniel Kahneman, Amos Tversky, Richard Thaler, and Paul Slovic. These errors in reasoning lead most investors to avoid high-value stocks and buy growth stocks at expensive prices, which allow those who reason correctly to profit from bargains in neglected value stocks and the overreacted selling of growth

stocks.
Empirical evidence has been mixed, but has generally not supported strong forms of the efficient markets hypothesis[5][6] [19] According to Dreman, in a 1995 paper, low P/E stocks have greater returns.[20] In an earlier paper he also refuted the assertion by Ray Ball that these higher returns could be attributed to higher beta,[21] whose research had been accepted by efficient market theorists as explaining the anomaly[22] in neat accordance with modern portfolio theory.
One can identify "losers" as stocks that have had poor returns over some number of past years. "Winners" would be those stocks that had high returns over a similar period. The main result of one such study is that losers have much higher average returns than winners over the following period of the same number of years.[23] A later study showed that beta (β) cannot account for this difference in average returns.[24] This tendency of returns to reverse over long horizons (i.e., losers become winners) is yet another contradiction of EMH. Losers would have to have much higher betas than winners in order to justify the return difference. The study showed that the beta difference required to save the EMH is just not there.
Speculative economic bubbles are an obvious anomaly, in that the market often appears to be driven by buyers operating on irrational exuberance, who take little notice of underlying value. These bubbles are typically followed by an overreaction of frantic selling, allowing shrewd investors to buy stocks at bargain prices. Rational investors have difficulty profiting by shorting irrational bubbles because, as John Maynard Keynes commented, "Markets can remain irrational longer than you can remain solvent."[25] Sudden market crashes as happened on Black Monday in 1987 are mysterious from the perspective of efficient markets, but allowed as a rare *statistical event* under the Weak-form of EMH. Burton Malkiel, a well-known proponent of the general validity of EMH, has warned that certain emerging markets such as China are not empirically efficient; that the Shanghai and Shenzhen markets, unlike markets in United States, exhibit considerable serial correlation (price trends), non-random walk, and evidence of manipulation.[26]
Behavioral psychology approaches to stock market trading are among some of the more promising alternatives to EMH (and some investment strategies seek to exploit exactly such inefficiencies). But Nobel Laureate co-founder of the programme—Daniel Kahneman—announced his skepticism of investors beating the market: "They're [investors] just not going to do it [beat the market]. It's just not going to happen."[27] Richard Thaler has started a fund based on his research on cognitive biases. In a 2008 report he identified complexity and herd behavior as central to the global financial crisis of 2008.[28]

Recent Financial Crisis

The recent global financial crisis has led to renewed scrutiny and criticism of the hypothesis.[29]
Market strategist Jeremy Grantham has stated flatly that EMH is responsible for the current financial crisis, claiming that belief in the hypothesis caused financial leaders to have a "chronic underestimation of the dangers of asset bubbles breaking".[30]
At the International Organization of Securities Commissions annual conference, held in June 2009, the hypothesis took center stage. Martin Wolf, the chief economics commentator for the Financial Times, **dismissed the hypothesis as being a useful way to examine how markets function in reality**. Paul McCulley, managing director of PIMCO, was less extreme in his criticism, saying that **the hypothesis had not failed, but was "seriously flawed" in its neglect of human nature**.[31]

Appendix C. What can replace efficient markets theory?

http://www.ft.com/cms/s/0/cf6d096a-6d7a-11de-8b19-00144feabdc0.html?nclick_check=1

What can replace efficient markets theory?

By Jonathan Davis

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The most interesting thing about the efficient markets hypothesis is not whether it is valid or not – clearly it is not – but how it has managed to remain so influential for so long. At a recent conference in London on the subject, organised by the CFA Institute, Professor Andrew Lo of Massachusetts Institute of Technology offered the audience a simple explanation: "physics envy".

This was a reference back to the early inspiration of the Nobel economics laureate Paul Samuelson, who set out to find for economics a set of fundamental laws that would do for the dismal science what Newton's laws of thermodynamics had done for physics, and from which a rigorous general theory with practical uses could subsequently be developed.

Using such building blocks as utility theory, equilibrium and the principle of no arbitrage ("no free lunches"), this led Mr Samuelson and his many successors to develop what we have come to know as the discipline of microeconomics that is universally taught to every finance and economics student at university and business school. The efficient markets hypothesis and the notion that stock prices follow a random walk are offshoots of this approach.

The attempt to bring order and an overarching theoretical framework into analysis of the seemingly unruly behaviour of financial markets was a temptation that has for years proved too great for academics (and many market participants) to resist, but it has turned out to be a long and largely fruitless journey.

The problem of course, as Prof Lo has helped to demonstrate with his empirical studies of the random walk, is that the financial markets simply don't lend themselves to deductive theory as well as the physical world.

If a theoretical approach is not firmly grounded, it is not surprising that the predicted consequences that flow from it should fail to show up consistently in the way that investors and markets actually behave.

Behavioural finance has grown to become a popular alternative approach precisely because it does appear to explain more clearly how investors, individually and collectively, appear to act.

In Prof Lo's words: "Economic systems involve human interactions, which almost by definition are more complex than interactions of inanimate objects governed by fixed and known laws of motion."

The real beauty of the efficient markets hypothesis, and the explanation for its longevity in the face of consistent empirical evidence that it is invalid, surely lies in its beguiling simplicity.

As the future is uncertain and many of the key variables that concern investors cannot be predicted with confidence, a theoretical structure that appears to offer a way to live with uncomfortable reality has obvious attractions.

Prof Lo's own response has been to develop what he calls the adaptive market hypothesis, which seeks to draw on the insights of neuroscience and evolutionary biology. The hypothesis aims to create a framework that seeks to relate the behaviour of financial markets to a number of different factors, including the emotional condition of market participants at different points in time and the current balance of advantage between competing groups of market participants.

"Market efficiency," he says "cannot be evaluated in a vacuum, but is highly context-dependent and dynamic, just as insect populations advance and decline as a function of the seasons, the number of predators and prey they face, and their abilities to adapt to an ever-changing environment."

What is at work in financial markets, he believes, is a Darwinian process of "survival of the richest".

The implications of this approach are interesting. One is that the relationship between risk and return will not be stable over time, which seems right both intuitively and empirically. Another is that, rather than markets becoming steadily more efficient over time, as early proponents of the EMH proclaimed, this world is one in which new profit opportunities will continue to emerge at a constant rate.

This is the engine that provides the continuing incentive for active managers to remain in the market.

But they will need to be innovative and adaptive to changing market conditions if they are to remain successful, Prof Lo argues. One-trick ponies risk going out of business before their kind of market next comes around.
Most important of all, investors cannot rely on the comforting message of the efficient market hypothesis that all you need to do to obtain an expected return is to take the appropriate level of risk.
The biggest problem with this new approach, as with all alternatives to EMH, including behavioural finance, is that it doesn't give investors a simple metric for understanding what to do.
Its great merit, however, is that it appears to relate to the complex and uncertain world that we all actually inhabit, something the efficient markets hypothesis has never done.

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Appendix D. Views of George Soros. The USA has been pursuing market fundamentalism.

http://en.wikipedia.org/wiki/George_Soros#Reflexivity.2C_financial_markets.2C_and_economic_theory

Reflexivity, financial markets, and economic theory

Soros' writings focus heavily on the concept of reflexivity, where the biases of individuals enter into market transactions, potentially changing the perception of fundamentals of the economy. Soros argues that such transitions in the perceptions of fundamentals of the economy are typically marked by disequilibrium rather than equilibrium, and that the conventional economic theory of the market (the 'efficient market hypothesis') does not apply in these situations. Soros has popularized the concepts of *dynamic disequilibrium*, *static disequilibrium*, and *near-equilibrium* conditions.[15]

Reflexivity is based on three main ideas[15]:

1. Reflexivity is best observed under special conditions where investor bias grows and spreads throughout the investment arena. Examples of factors that may give rise to this bias include (a) equity leveraging or (b) the trend-following habits of speculators.
2. Reflexivity appears intermittently since it is most likely to be revealed under certain conditions; i.e., the equilibrium process's character is best considered in terms of probabilities.
3. Investors' observation of and participation in the capital markets may at times influence valuations AND fundamental conditions or outcomes.

A current example of reflexivity in modern financial markets is that of the debt and equity of housing markets. Lenders began to make more money available to more people in the 1990s to buy houses. More people bought houses with this larger amount of money, thus increasing the prices of these houses. Lenders looked at their balance sheets which not only showed that they had made more loans, but that their equity backing the loans--the value of the houses, had gone up (because more money was chasing the same amount of housing, relatively). Thus they lent out more money because their balance sheets looked good, and prices went up more, and they lent more. This was further amplified by public policy. Many governments see home ownership as a positive outcome and so first home owners grant and other financial subsidies - or influences to buy a home such as the exemption of a primary residence from capital gains taxation - mean that house purchases were seen as a good thing. Prices increased rapidly, and lending standards were relaxed. The salient issue regarding reflexivity is that it explains why markets gyrate over time, and do not just stick to equilibrium--they tend to overshoot or undershoot.[15]

View of potential problems in the free market system

Despite working as an investor and currency speculator, he argues that the current system of financial speculation undermines healthy economic development in many underdeveloped countries. Soros blames many of the world's problems on the failures inherent in what he characterizes as market fundamentalism. His opposition to many aspects of globalization has made him a controversial figure.

Victor Niederhoffer said of Soros: "Most of all, George believed even then in a mixed economy, one with a strong central international government to correct for the excesses of self-interest."

Soros claims to draw a distinction between being a participant in the market and working to change the rules that market participants must follow. According to Mahathir bin Mohamed, Prime Minister of Malaysia from July 1981 to October 2003, Soros - as the hedge fund chief of Quantum - may have been partially responsible for the economic crash in 1997 of East Asian markets when the Thai currency relinquished its peg to the US dollar. According to Mahathir, in the three years leading to the crash, Soros invested in short-term speculative investment in East Asian stock markets and real estate, then divested with 'indecent haste' at the first signs of currency devaluation. [48] Soros replied, saying that Mahathir was using him "as a scapegoat for his own mistakes", that Mahathir's promises to ban currency trading (which Malaysian finance officials hastily retracted) were "a recipe for disaster" and that Mahathir "is a menace to his own country".[49]

In an interview regarding the economic crisis of 2008, Soros referred to it as the most serious crisis since the 1930s. According to Soros, market fundamentalism with its assumption that markets will correct themselves with no need for government intervention in financial affairs has been “some kind of an ideological excess”. In Soros´ view, the markets´ moods — a “mood” of the markets being a prevailing bias or optimism/pessimism with which the markets look at reality — “actually can reinforce themselves so that there are these initially self-reinforcing but eventually unsustainable and self-defeating boom/bust sequences or bubbles”.[50]

Appendix E. Market Fundamentalism

http://www.longviewinstitute.org/projects/marketfundamentalism/marketfundamentalism

Market Fundamentalism

Longview's project on Market Fundamentalism is intended as a resource to explain what Market Fundamentalism is, examine its impact on politics and policy, and provide powerful critiques of its key arguments. We plan to keep expanding and developing this resource over time.

Market Fundamentalism—Definition

Market Fundamentalism is the exaggerated faith that when markets are left to operate on their own, they can solve all economic and social problems. Market Fundamentalism has dominated public policy debates in the United States since the 1980's, serving to justify huge Federal tax cuts, dramatic reductions in government regulatory activity, and continued efforts to downsize the government's civilian programs. While Republicans and conservatives have embraced Market Fundamentalist ideas, many Democrats and liberals have also accepted much of this mistaken belief system.

Why is it so important to identify and challenge Market Fundamentalist ideas?

Market Fundamentalism is a huge barrier to progressive change in the United States. Its ideas have been used to discredit taxes, regulation of business, and good quality public services. We cannot solve any of our most pressing problems—from global climate change to our dysfunctional health care system to our flawed foreign policies—as long as Market Fundamentalism restricts our policy choices.

Over the last twenty years, progressives have usually avoided directly taking on Market Fundamentalism because it has persuaded so many people. For example, in mounting campaigns for a living wage or to increase the statewide minimum wage, progressives have made powerful moral arguments without addressing directly the question of whether markets do an adequate job of setting wage levels. The hope is that winning a concrete reform would gradually erode the public's support for Market Fundamentalist ideas. But bad ideas don't simply go away; they have to be challenged and defeated.

Chipping away at Market Fundamentalist policies is important, but to win lasting victories, we need to change the way that people think about the economy. It is important that people see the economy not as an impersonal mechanism that churns out efficient outcomes, but as a set of institutions that can be shaped to serve our needs. Unless we can change the basic assumptions that lead many people to be hostile to taxation or doubt the ability of government to provide quality services, then our political options will remain very restricted.

Why now?

Market Fundamentalism is now particularly vulnerable to challenge. For more than twenty-five years, its proponents have argued that lower taxes, less regulation, and fewer government services would make us all more prosperous. Even the White House's own web page shows us that Apple's Ipod relies on technologies that were developed through the Federal Government's initiatives. The President constantly repeats that individuals will always spend money more wisely than government, but the reality is that public spending has been indispensable to our economy's development.

Myths of Market Fundamentalism

We will gradually add both additional myths and arguments against each of the myths:

1. The market is the only source of innovation and it must be left alone if we want to accelerate technological change.
2. Government will always spend money less productively than private citizens; this is why tax cuts are almost always a good idea.
3. Regulation of business is wasteful, unproductive and usually unnecessary.
4. Financial markets thrive when regulation is kept to a minimum.
5. Private firms will always produce a good or a service more efficiently than the government.
6. It is wrong to regulate wages or executive compensation because markets always get prices right.
7. Government assistance always ends up hurting the people it is supposed to help.

http://www.longviewinstitute.org/projects/marketfundamentalism/myth4

Market Myth Four: Financial Markets Thrive when Regulation is Kept to a Minimum

People in the U.S. love to gamble; we spend billions on state lottery games, in Las Vegas and other gaming meccas, as well as betting on horses, football, and basketball. Moralists debate endlessly as to whether this is a harmless pastime or the mark of a declining civilization. But as John Maynard Keynes reminded us during the Great Depression, "When the capital development of a country becomes the by-product of a casino, the job is likely to be ill done." The role of hedge funds in the recent meltdown of the home mortgage market is a powerful reminder of his wisdom.

Market fundamentalists have reconstructed U.S. capital markets along the lines of a casino for the last two and a half decades. With the help of huge flows of money from the wealthiest households, financial “engineers” have created a whole set of largely unregulated investment vehicles that promise returns that are much higher than ordinary stocks or bonds. Using their political clout in Washington, D.C., they have been allowed to do exactly what Keynes warned against.

Hedge funds - large pools of money that are free to pursue very risky investment strategies because they fall under a loophole in the system of financial regulation - are one of their key achievements. They now have more than one trillion dollars under management in the U.S., and there is substantially more overseas since many of these funds operate through tax havens like the Cayman Islands. Their success in earning high returns has led both banks and pension funds to become business partners with, and investors in, these risky vehicles. One of the key factors in the collapse of Bear Stearns, the venerable Wall Street investment bank, was that several of their hedge funds suffered huge losses.

Hedge funds are free to borrow unlimited amounts, and in recent years, banks have fallen all over each other to offer them as much credit as they want. Thus, hedge funds can invest 100 million dollars in some very risky asset when they only have $10 million on hand. Why would they do this? If a subprime mortgage bond were paying interest of 12% per year, and the bank was willing to lend to the hedge fund at 5% per year, the hedge fund makes $700,000 additional profit for every extra $10 million they borrowed. But, of course, when those mortgage bonds went South, many hedge funds could not repay their loans and **the global financial system began to seize up.**

Hedge funds have been putting billions of dollars into asset classes that only a few people understand. For example, in 1995, a 34-year old mathematician from Cambridge University working at J.P Morgan invented something called a Credit Default Swap. Basically, a CDS is a way for owners of debt to insure themselves by paying a third party - usually a hedge fund - to assume the risk of default. This sounds good in theory, but in practice, CDSs were often traded recklessly among hedge funds and institutions, regardless of whether the new buyer actually had the ability to assume the risk they are taking on. They eventually came to have a staggering market value of over $45 trillion, and they helped fool the market participants into believing that they were protected if things turned bad.

The current recession is a direct result of major financial institutions being exposed to the risks created by hedge funds and these exotic financial instruments. Even firms as large as Bank of America have been impacted because of their substantial loans to hedge funds. Heavy losses among these major global banks have forced them to raise tens of billions of dollars in new capital, much from foreign governments.

The U.S. financial landscape currently resembles a glitzy Vegas casino, and the gamblers at the table are making bets large enough to bring down the house. J.M Keynes was right, and Treasury Secretary Paulson’s “market-based” reforms are not enough to straighten up these gambling addicts. The U.S. needs to regulate hedge funds, just like any other responsible asset class, and it should reinstate mandatory separation of investment and commercial banking activities. Not everyone, after all, wants their future to be riding on the fortunes of a casino.

Appendix F. Current view on Efficient Market Theory by the father of Efficient Market Theory. (Fama)

http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=1134

Interview with Eugene Fama
A conversation with the intellectual father of efficient market theory, Eugene Fama, passive portfolio management, and value and small cap mutual funds.
Douglas Clement - Editor, The Region
December 2007

Interview conducted November 2, 2007.
Few economists have had greater influence on financial theory, and practice, than Eugene Fama. His 1964 doctoral dissertation, "The Behavior of Stock Market Prices," suggested that stock markets are efficient. Because of competition among investors, company share prices respond swiftly to past events, current information and future expectations. Actual prices are good estimates of intrinsic value, therefore, and no analyst can find consistent, profitable anomalies.

And price trends are random, said Fama. Past patterns don't predict future directions. Published in a nontechnical article a year later, his research popularized the "efficient market hypothesis" and "random walk theory."
Fama's work soon transformed Wall Street, and later Main Street, by giving rise to a proliferation of low-cost index funds, as many questioned the value of paying for active portfolio management. "If one takes into account the higher initial loading charges of the [mutual] funds," he observed over 40 years ago, "the random investment policy outperforms the funds."
More recently, and often in collaboration with Dartmouth's Kenneth French, Fama reexamined the capital asset pricing model, a classic model for determining fair cost for equity capital, and declared it an empirical failure unless two other factors, market capitalization and book value to market value, are also included. This work, too, has transformed Wall Street by providing academic support for "small-cap" and "value" funds.
Fama has done significant research in other areas, consistently sustaining connections between financial economics and macroeconomic theory. But his illumination of financial markets will undoubtedly be recognized as the University of Chicago scholar's paramount contribution to both research and reality.
"Eugene Fama has had pathbreaking insights into the functioning of markets, asset-pricing theory, and corporate finance," Nobel laureate Myron Scholes noted recently, "[insights] that have benefited market participants worldwide."

Principal-Agent Issues

Region: In the early 1980s, you authored three key pieces regarding principal-agent conflicts [due to differing incentives of an organization's owners and employees] and how they play out efficiently in various types of organizations. How have your ideas evolved in light of transformations in the corporate world?

Fama: I haven't spent a lot of time on these issues since then, but they keep popping up. I haven't seen anything that would cause me to change my opinions generally, but something that has bothered me is the drying up of the takeover market due to the installation of antitakeover provisions by most companies, enabled by state legislatures.

Region: Poison pills and the like?

Fama: Right, and that is very unhealthy, I think, for the corporate world because it takes away the threat of outside takeovers, which is very important for the economy.

Region: A form of market discipline.

Fama: Yes, it's a unique discipline that corporations have that other forms of organization don't have. For example, it's very difficult to attack the University of Chicago in that way. It doesn't need a takeover defense because there's no real way to attack it. For a corporation, on the other hand, there was a way. That allowed corporations to have expert boards because the board wasn't the court of last resort. But the institution of all antitakeover amendments threw a wrench in the process.

CEO COMPENSATION

Region: Another issue those papers touched on was compensation of CEOs, a controversial question in recent years. How do you view the suggestion that some CEOs are overcompensated?

Fama: If the [compensation] process gets captured by the CEO, then it can get corrupted. But if what you're seeing is a market wage, then I don't know why you would say it's too high. If it's a market wage, it's a market wage. I don't know of any solid evidence that the process was corrupted. So my premise would be that you're just looking at market wages. They may be big numbers; that's not saying they're too high. It's easy to say that people are paid too much, but when you're on the other side of the fence trying to hire high-level corporate managers, it turns out not to be so easy.

EFFICIENT MARKET THEORY

Region: Can you give us a lay definition of the efficient market hypothesis? How does it differ from random walk [the idea that movements in stock prices are unpredictable]? And what is the genesis of efficient market theory?

Fama: The basic wording of it is very simple. It says prices reflect all available information. The conundrum is how to determine whether prices reflect all available information, and you can't do that without a model of market equilibrium. What I added to the story was just pointing out that you need a model of market equilibrium in order to carry out the tests of market efficiency.

In the early 1960s, the advent of computers allowed people to do things with data that they couldn't do before. And the most easily available data was stock market data. So lots of people started working on stock market returns, and the question arose, well, what would we expect if markets were working properly? "Random walk" was the first manifestation of that. But it's kind of a clumsy statement because it doesn't recognize that you need a model of market equilibrium to decide what the market's trying to do in setting prices.

Region: So that is the "joint hypothesis."

Fama: Right. The joint hypothesis problem says that you can't test market efficiency without a model of market equilibrium. But the reverse is also true. You can't test models of market equilibrium without market efficiency because most models of market equilibrium start with the presumption that markets are efficient. They start with a strong version of that hypothesis, that everybody has all relevant information. Tests of market efficiency are tests of some model of market equilibrium and vice versa. The two are joined at the hip.

Once I pointed that out, it was clear that the random walk model was kind of irrelevant. You could have prices not following random walks because the model of market equilibrium could generate expected returns that had some predictable time-varying patterns to them. So the whole nature of the game

changed.
Region: The idea that things are unpredictable doesn't necessarily mean that they're efficient.
Fama: No, not necessarily. Sure, prices could be random and still be inefficient. Basically, what market efficiency says is that the deviation of the realized price from the equilibrium expected value is unpredictable based on any past information.
Region: Can you tell us about the genesis of this idea? You were at Tufts University at the time, I believe.
Fama: When I was at Tufts, I was working for a professor who had a stock market forecasting service. My job was to devise rules for predicting the market, and I was very good at it. But he was a pretty good statistician. He always told me to set some data aside so I could test [the rules] out of sample. And they never worked out of sample.*

So when I came to the University of Chicago and people were talking about these things, it suddenly dawned on me that maybe that was the nature of the game, that there just wasn't much predictability of returns because markets were working efficiently. That was the beginning of the story.

There were lots of people at Chicago and at MIT who were very interested in that issue. Merton Miller. Franco Modigliani. Paul Cootner. Paul Samuelson was very interested in it. And Benoît Mandelbrot.
Region: The subject of your first paper, I think.
Fama: Right. Half of my thesis was on the predictability of returns and the other half was on the nature of the return distribution, which was what Mandelbrot was all about, and still is.

IRRATIONAL EXURBERANCE

Region: Some economists—you know them well—say that the stock market crash of 1929 and the more recent climb and decline of the market in the early 2000s suggest that "irrational exuberance" affects the stock market. How do you reconcile this alleged evidence of herding behavior and animal spirits with the notion of market efficiency?
Fama: Well, economists are arrogant people. And because they can't explain something, it becomes irrational. The way I look at it, there were two crashes in the last century. One turned out to be too small. The '29 crash was too small; the market went down subsequently. The '87 crash turned out to be too big; the market went up afterwards. So you have two cases: One was an underreaction; the other was an overreaction. That's exactly what you'd expect if the market's efficient.

The word "bubble" drives me nuts. For example, people say "the Internet bubble." Well, if you go back to that time, most people were saying the Internet was going to revolutionize business, so companies that had a leg up on the Internet were going to become very successful.

I did a calculation. Microsoft was an example of a corporation that came from the previous revolution, the computer revolution. It was hugely profitable and successful. How many Microsofts would it have taken to justify the whole set of Internet valuations? I think I estimated it to be something like 1.4.
Region: About one and a half Bill Gateses.
Fama: That's right. And Microsoft was a good example because the worse their products were, the more money they made [laughter]. Who didn't struggle with DOS and then the first versions of Windows?

INTERNATIONAL EQUITY MARKETS

Region: Are all stock markets equally efficient? Is the Hang Seng as efficient as the Nasdaq as the Australian stock exchange? If not, are there money-making opportunities internationally that don't exist in the United States?
Fama: Anybody who has studied that issue doesn't come to the conclusion that there are huge opportunities in other markets that don't exist in the United States. That's kind of a standard line of international money managers, that the opportunities are better in international markets. That's certainly not true in developed markets.

In emerging markets, well, I think maybe insiders have more information than they do in domestic markets, but maybe not. In any case, there's not enough data to know about emerging markets. And the variances are so big it would be impossible to know anyway. When people study money managers in developed markets, they don't find any evidence that those markets are inefficient … and there's very little evidence that they're inefficient in the United States. But I've never taken the extreme position that markets are entirely efficient.

HAS FAMA SOFTENED?

Region: I was going to ask you about that. As you know, I'm sure, there was a lengthy *Wall Street Journal* profile of you and your colleague Richard Thaler in 2004, suggesting that you had softened a bit.

Fama: [Laughter].

Region: And I'm wondering if that was accurate or if you've always believed that markets are less than perfectly efficient?

Fama: I start my class every year by saying, "These are models. And the reason we call them models is that they're not 100 percent true. If they were, we would call them reality, not models. They're simplifications." But the acid test is, How good are the simplifications for your purposes? And for almost all purposes, market efficiency is a very good approximation. There is very little evidence that money managers can beat the market.

DIMENSIONAL FUND ADVISORS

Region: Then this is the right time to ask, I guess, about Dimensional Fund Advisors, on whose board you sit. Why should an investor pay a management fee to Dimensional Fund when an index fund might provide efficient returns at lower cost?

Fama: Well, Dimensional is a passive manager. They don't charge high fees. Vanguard, for example, is another passive manager that charges very low fees. You shouldn't pay managers very much. The average management fee for an actively managed mutual fund is about 1 percent. There's no evidence that they generate anything for that 1 percent. So my answer is, I don't know why anybody buys them.

Region: And yet we keep doing it, don't we?

Fama: Well, people want to think there's money left on the table for them.

THREE-FACTOR MODEL

Region: With Kenneth French, you've said that the capital asset pricing model (CAPM) developed by John Lintner and William Sharpe has "fatal problems" in explaining stock market returns because of its reliance on beta [the volatility of an individual stock relative to overall market volatility]. And you've found that two other factors are crucial for determining prices. Can you tell us about these factors? Are they inefficiencies, or do they represent hidden risk? And is the CAPM truly dead?

Fama: Let me first tell you what the returns evidence says, and then we can talk about how to interpret it. The returns evidence basically says that if you look at the CAPM market beta, it's not enough to describe the cross section of average returns.

The CAPM says that all you need to know are these market betas, market sensitivities, in order to fully describe the cross section of average returns. What you find is that other variables contribute to the explanation of average returns above and beyond what you get from beta. Indeed, over the last 50 years, you get very little at all from beta.

The two variables that we've focused on are market capitalization (the financial profession calls it size, a misnomer because it's really market capitalization) and the book-to-market ratio, the ratio of the book value of a common equity to its market value. Now, there's no magic in that ratio. The ratio of almost anything to price will work as well. These are the two variables.

So, small-cap stocks have higher average returns than large-cap stocks, and stocks with higher ratios of book value to market value have higher returns than low book-to-market stocks. Low book-to-market stocks tend to be growth stocks. High book-to-market stocks tend to be relatively more distressed; they're what people call value stocks. That's given rise to what the finance profession—academic as well as applied—calls the size premium and the value premium. The value premium tends to be bigger.

So the issue then is, Are these risk factors or market inefficiencies? One group of people says they're market inefficiencies—particularly the value premium. The behaviorists tend to say the value premium is a market inefficiency. Their story is: The market overreacts to good and bad past times. It doesn't understand that things tend to mean revert. So growth companies that have done very well tend to be overpriced, and value companies that have done poorly tend to be underpriced, and then the market realizes this and corrects it. And this story says, basically, that people are dumb; they never learn. So every generation of growth stocks and value stocks goes through the same sort of cycle.

That's not too appealing to an economist—the idea that people never learn about these things—but that is the behavioral story. And initially they said these are arbitrage opportunities because if you go long value stocks and short growth stocks, you get something with a variance close to zero.

But French and I pointed out that if you do that, you get something with a variance very close to the market *variance*, not zero. It's quite a risky strategy. And the premium is about the size of the market premium. So it looks and smells like a risk premium. And we developed a three-factor model with a size premium in addition, basically the difference between the returns on small stocks and big stocks.

So, our model has three factors. Every asset pricing model says you need the market in there. Then they differ on how many other things you need. The CAPM says you only need the market. We basically say a minimum of two other factors seem to be necessary. And these two do a pretty good job.

There's still a *third* explanation, which is not based on overreaction. It says that people just don't like small stocks and value stocks. There's some amount of utility that people get from the nature of the stocks that they hold. So they like big stocks and they like growth stocks, and they're willing to hold them even though they have lower average returns.

Now you can't have an arbitrage opportunity there because then there'd be a sure profit. But the fact that they look like risk factors can sustain that story. You can't tell the difference between that story and a risk story.

MOMENTUM

Region: Let me ask you about momentum. You've said that it's the strongest challenge to the hypothesis of market efficiency. Can you elaborate on that?

Fama: There's evidence that if you rank stocks every month based on their last year of returns, the very extreme winners tend to win for a few more months and the losers tend to lose for a few more months.

That seems to be true in U.S. data beginning around 1950. We don't have foreign data going back that far, but it tends to be there in major foreign markets except for Japan. It doesn't tend to be there in the U.S. data for the '30s and '40s. So there's some chance that it is just a chance result. There are so many people looking for anomalies in the data, that may just be the biggest one that they've found. Maybe it won't be there in the future. We don't know yet.

Region: Is there an opportunity to make money there?

Fama: Well, there isn't much of an opportunity to make money, because as I said, you do this every month. And if you rank and trade stocks every month, the turnover of these portfolios is enormous.

Region: The costs will eat up the profits.

Fama: Right. The costs will kill you. So the people who have written these papers have said, basically, "This is interesting, but forget about trading on it." But it's still interesting.

HOUSING MARKETS

Region: Your efficient market hypothesis applies to stocks, of course. Recent events have led to scrutiny of housing markets. Are housing markets efficient? Is there greater potential for irrationality to crop up there, either because housing investors are less sophisticated than stock market investors or because housing markets are less liquid?

Fama: I don't know. Housing markets are less liquid, but people are very careful when they buy houses. It's typically the biggest investment they're going to make, so they look around very carefully and they compare prices. The bidding process is very detailed. The bottom line is that real estate is a huge component of wealth and we have no data on it. So the answer to your question is, Who knows?

CREDIT MARKETS

Region: Some observers have suggested that regulators and others have put too much reliance on ratings agencies to determine the risk of mortgage-backed securities and that even financially sophisticated parties "didn't really know what they were buying." Is this evidence that credit markets are inefficient?

Fama: That story just doesn't appeal to me. First of all, it's well known that rating agencies tend to lag actual changes in credit worthiness. For example, stock prices predict changes in ratings better. The best models of credit quality are basically options pricing models that work off the stock price. So I'm very skeptical of these stories.

The bond market is a simpler market than the stock market. Bonds are simpler to evaluate than stocks, because there's downside risk, but you don't have to worry much about the upside: They're not going to pay you more than they promised. So bonds are much simpler to deal with. Now bond products have become more complicated because of the securitization of that market, but still not that big a deal.

NEW FINANCIAL TECHNOLOGIES

Region: What about hedge funds, collateralized debt obligations and other newer financial technologies—do they serve a useful purpose in mitigating market risk, or do they heighten it?

Fama: I don't know. People talk on both sides of that issue. The problem is that we don't have very good hedge fund data and the data we have only goes back about 10 years. That's just not enough to come to any conclusions on these issues. So I don't know if it's going to take another half century before we really know. You're talking about returns with such high volatility that it really is going to take that long.

This is a standard part of a talk that I give to investment professionals: People like to tell stories about short periods of data, but the reality is that you can't measure the market premium over periods shorter than an investment lifetime. The 5 percent stock market premium over bills takes about 35 years before it becomes two standard errors from zero.

EQUITY PREMIUM

Region: How do you explain the equity premium puzzle [the idea that stocks should in theory provide only a 1 percent higher annual return than bonds, but have historically returned nearly 7 percent more]?

Fama: In terms of these consumption-based asset pricing model stories? What I say to the consumption people is: You're telling me the premium should be about 1 percent a year. Well, you wouldn't be able to tell the difference between that and zero over a 1,000-year period. And for a 1 percent a year premium, who do you know that would hold stocks? It's this representative investor, but who is that guy anyway? I wouldn't hold them. I don't know anybody else who would. So there's got to be something missing in those models.

ARE BANKS STILL SPECIAL?

Region: In 1985, you wrote a paper titled "What's Different About Banks?" It's a question often discussed by the Fed, for obvious reasons. You wrote that special monitoring services and special transactions services, including the checking system, are part of what makes them unique. As other nonbank organizations take over some of the roles, are banks no longer so different, no longer as special?

Fama: Excellent question. Basically, the only companies that can issue debt publicly are very large companies. I mean directly issue debt, commercial paper or marketable bonds. Everybody else has to go to an institution. Now what institutions have done is to securitize these things, put them into bundles and put them on the market. Lots of people have been working on the extent to which the monitoring function as a consequence has been diluted somewhat because the banks aren't holding 100 percent of the paper that they create. So that's an ongoing issue. I don't know what the answer is about whether banks are less relevant now. They're doing a lot more different things than they ever did, but so are all financial institutions.

SSRN

Region: You and Michael Jenson helped create the Financial Economics Network, which then broadened into the Social Science Research Network. What role do you see it playing in the future in the creation and distribution of economic research?

Fama: I think it's great for working papers, but I don't think you can do without the refereeing process. Will all journals end up online? I think that's a good possibility. But the refereeing process is still critical for quality, improving work and certifying work. So professional journals may change in nature, but that function will remain, and the editorial function will remain as a consequence.

FINANCE/MACRO

Region: It seems to me that macroeconomists are paying more attention these days to the work of financial economists, especially in trying to understand asset pricing. Do financial economists find equal value in the macro theory work being done these days?

Fama: I think those two areas have always been pretty closely joined. I, in fact, wrote a lot of macro-related stuff in the '80s or even earlier. For example, rational expectations stuff is basically efficient markets; they're pretty much the same thing. If you're talking about the macroeconomy, I don't see how you can avoid financial markets. That's a big part of the game. Nobody talks about money and bonds anymore the way they did when I was taking macroeconomics. Now people realize it is a lot more complicated. Finance and macro are joined. Our finance faculty has several people who were trained as macroeconomists, especially on the asset pricing side.

TIME ALLOCATION

Region: I understand that you work every day, even holidays. Is that right?

Fama: Right.

Region: That's an amazing work ethic.

Fama: Not really.

Region: I've also heard that you're a dedicated athlete.

Fama: Right. I work every day, but I never work a full day. I get up at five o'clock in the morning and I work basically all morning until maybe one o'clock, two o'clock, and then I go play golf, I go windsurfing, I play tennis. And that's it.

Region: We should let you go then. Thank you very much.

—Douglas Clement
Nov. 2, 2007

Appendix G. Regulators should tap the knowledge of market experts – to help create better regulation.

http://www.ft.com/cms/s/0/971766f8-71a0-11de-a821-00144feabdc0.html?nclick_check=1

In short, those sellers can be a mine of information

By Anthony Bolton

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As the dust has settled on the financial crisis, there has been much debate about what changes to the system should occur to avoid a repetition of the past two years. A recurring theme has been the role played by hedge funds and in particular whether the practice of short selling bank shares was a major contributor to last autumn's instability.

At the height of the sell-off, the UK's Financial Services Authority imposed a ban on shorting financial stocks and since this was lifted in January the regulator has required disclosure of short positions in a list of vulnerable companies. In some other markets bans remain in force.

At the time, there was a good case for the moratorium on shorting bank shares. The temporary ban on shorting financial stocks was justified because a potentially self-fulfilling downward spiral had been created, with falling share prices undermining confidence, prompting the withdrawal of credit lines and threatening banks with collapse.

With the benefit of hindsight, the ban may have been a step too far, although we can never know this.

Also, if the purpose of the ban was to prevent prices falling, it failed - the shares of Royal Bank of Scotland, Lloyds and Barclays all fell by more than half while the ban remained in force. None of this means that the FSA was wrong to err on the side of caution.

The shorting of bank shares was, however, a symptom rather than a cause of the financial crisis. Now we know what the banks were up to, it is clear that the ones that failed required no assistance in destroying their businesses. They did a perfectly good job themselves.

The financial crisis was a consequence of poor management, inadequate regulation, over-stimulative monetary policy and deficient analysis by ratings agencies.

If hedge funds profited from this combination then it is only because they saw it earlier and more clearly than other market participants.

Short sellers claim, with some justification, that their activities play a useful role in making markets more efficient. By seeking to profit from the over-optimism of investors who have driven prices too high, they oil the markets' price-setting mechanism.

Even those who do not wholeheartedly share this view, would probably acknowledge that hedge funds were the canary in the mineshaft in 2007.

But the frenetic activity of companies and simultaneous inactivity of the regulators in the run up to the credit crunch illustrates how their siren calls were largely ignored at the time. Far from profiting from the misery of others, many short sellers discovered that being too early can also be painful.

Far from attempting to stamp them out or ignoring them and hoping they will go away, *I believe that regulators should recognise the skill with which some hedge funds read the approaching disaster and try to learn something from them.*

The best hedge funds represent a body of well-informed investors who have done extensive work on the risks of both individual companies and the financial system as a whole.

Perhaps most importantly, they have then invested large amounts of money behind their theses.

I believe it is essential that regulators have access to the thinking of the more successful hedge funds (there are probably only half a dozen or so that they would need to engage with) and I would encourage the FSA and the Bank of England to have regular informal meetings with them.

I would be surprised if these meetings did not provide extremely useful early warnings of problems ahead and they could, and should, be conducted behind closed doors.

I would take this argument one step further. For the regulator the most useful lessons can be learned from the extensive research that underpins the short-selling of financial stocks.

But companies in all sectors could benefit from more active engagement with hedge funds that are short of their shares to understand why they have taken a negative position.

It might be a good way of finding out about risks they have overlooked or failed to discuss at board level.

In particular, non-executive directors, whose job it is to worry about the risks that their executives might not be taking seriously, should take the lead.

The benefit would, moreover, be mutual. Hedge funds would gain useful intelligence about their insights from a management's response - positive or negative.

Know your enemy, even if (especially if) it is the enemy within.

It's time short sellers were viewed in the boardroom and by regulators not as the devil incarnate but as a potential mine of information that could help forestall a repeat of last year's near-death experience.

The writer is President, Investments at Fidelity International

Appendix H. Greenspan admits 'flaw' in ideology

http://www.theaustralian.news.com.au/business/story/0,28124,24548000-643,00.html
http://business.smh.com.au/business/greenspan-admits-ideology-was-flawed-20081024-57kl.html
http://english.aljazeera.net/business/2008/10/2008102316104396 7668.html

Greenspan admits 'flaw' in ideology

Greenspan said he was in a 'state of shocked disbelief' over the crisis [AFP]

Alan Greenspan, the former US Federal Reserve chairman, has publicly admitted that the US free-market ideology that he and others have championed for decades is flawed.

Greenspan, who headed the US central bank for more than 18 years, said on Thursday that he had "found a flaw ... in the model that I perceived is the critical functioning structure that defines how the world works".

The admission is one of the most significant comments made by a key architect of the world financial system that is now in chaos amid the global economic crisis.

His comments came as he gave evidence to the US House committee on oversight and government, which is seeking to discover if regulatory failings had contributed to the turmoil.

Henry Waxman, the committee chairman, asked Greenspan: "You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crises. You were advised to do so by many others and now the whole economy is paying its price.

"Do you feel that your ideology pushed you to make decisions that you wish you had not made?"

Greenspan replied: "Yes I found a flaw. I don't know how significant or permanent it is, but I've been very distressed by that fact."

'Grilled'

Al Jazeera's John Terrett, reporting from New York, said: "Greenspan used to be treated like a returning victorious general every time he went to Capitol Hill.

"During his 20 years as head of the US central bank, the Federal Reserve, Americans never felt better off.

"Today, it wasn't quite like that. It was a very different Alan Greenspan who was dragged back to Capitol Hill and grilled ... in came hostile questions about unfettered lending and lack of oversight.

"Gone was the usual deference for the man considered chief architect of America's 80s and 90s boom years.

Greenspan said he was shocked at the banks' inability to self-regulate and blamed over-eager investors for the sub-prime housing meltdown that led to the financial crisis, our correspondent said.

Greenspan's critics had accused him of leaving interest rates too low in the early part of the decade, spurring an unsustainable housing boom which went largely unregulated.

'Credit tsunami'

Admitting to the "flaw" in his free-market ideology, he said: "That is precisely the reason I was shocked, because I'd been going for 40 years or more with very considerable evidence that it was working exceptionally well."

Greenspan also said that the current crisis had "turned out to be much broader than anything that I

could have imagined".
He said that the current global financial crisis was a "once-in-a-century credit tsunami" which will have a severe effect on the US economy and drive unemployment higher.
He admitted he had also been "partially" wrong in opposing the regulation of derivatives in recent years.
He was joined by John Snow, the former treasury secretary, and Christopher Cox, the securities and exchange commission (SEC) chairman.
Waxman said that he believed that the Federal Reserve, which regulates banks, the SEC and the treasury had all played a role in contributing to the mistakes.

Many mistakes

Waxman, a Democrat, said: "The list of mistakes is long and the cost to taxpayers is staggering.
"Our regulators became enablers rather than enforcers. Their trust in the wisdom of the markets was infinite. The mantra became that government regulation is wrong. The market is infallible."
In his testimony, Greenspan blamed the problems on heavy demand for securities backed by subprime mortgages by investors who did not worry that the boom in home prices might come to a crashing halt.
"Given the financial damage to date, I cannot see how we can avoid a significant rise in layoffs and unemployment," Greenspan said.
"Fearful American households are attempting to adjust, as best they can, to a rapid contraction in credit availability, threats to retirement funds and increased job insecurity."

Bailout 'adequate'

Greenspan said that a necessary condition for the crisis to end will be a stabilisation in home prices, but he said that was not likely to occur for "many months in the future".
When home prices finally stabilise, Greenspan said, then "the market freeze should begin to measurably thaw and frightened investors will take tentative steps towards re-engagement with risk".
Greenspan said until that occurs, the government was correct in moving forward aggressively with efforts to support the financial sector.
He called the $700bn rescue package passed by the US congress on October 10 "adequate to serve the need" and said that its effect was already being felt in the markets.

Appendix I "Libertarian Dogma and the Fed" – Henry Kaufman

http://economistsview.typepad.com/economistsview/2009/04/libertarian-dogma-and-the-fed.html

Apr 28, 2009

"Libertarian Dogma and the Fed"

Henry Kaufman:

How libertarian dogma led the Fed astray, by Henry Kaufman, Commentary, Financial Times: The Federal Reserve has been hobbled by ... major shortcomings that were primarily responsible for the current and several previous credit crises.

...*My second major concern ... is the Fed's prevailing economic libertarianism.* ***At the heart of this economic dogma is the belief that markets know best*** *and that those who compete well will prosper, while those who do not will fail.*

How did this affect the Fed's actions and behaviour? First, *it explains to a large extent why the Fed did not strongly oppose the removal of Glass-Steagall restrictions*. Second, it also helps explain why the Fed failed to recognise that abandoning Glass-Steagall created more institutions that were "too big to fail".

Third, it diminished the supervisory role of the Fed... [The] Fed's ... tilt toward an economic libertarian approach pushed supervision a notch down just at a time when financial market complexity was on the rise.

Fourth, as hands-on supervision slackened, quantitative risk modelling became increasingly acceptable. This approach ... was far from adequate. But it worked hand in glove with a philosophy **that markets knew best.**

Fifth, adherence to economic libertarianism inhibited the Fed from using the bully pulpit or moral suasion to constrain market excesses. It is difficult to believe that recourse to moral suasion by a Fed chairman would be ineffective. ...

Sixth, the Fed's increasingly libertarian philosophy underpinned its view that it could not know how to recognise a credit bubble but knew what to do once a bubble burst. This is a philosophy plagued with fallacies. ...

By guiding monetary policy in a libertarian direction, the Fed played a central role in creating a financial environment defined by excessive credit growth and unrestrained profit seeking. ... At a minimum, the Fed's sensitivity to financial excesses must be improved.

Appendix J – ASIC arguing that consumer's better off to seek planning advice from institutions.

ASIC arguing for "vanilla" advice in the first public hearing of the PJC Inquiry – and ASIC also seems to be arguing that consumer's better off to seek planning advice from institutions.

It seems to me that:-

- On the one hand ASIC is arguing that consumers are better off dealing with an AMP or CBA financial planner (big end of town) because the big end of town will do the right thing to protect their reputations.
    - Note: ASIC conveniently ignores the fact that CBA have been found to be up to their arm-pits in the Storm Financial debacle – and that AMP had an enforceable undertaking after the last shadow shop because that had switched large numbers of investors into AMP superannuation products without a reasonable basis. Note: CBA and AMP only fixed these problems because they were sprung and had no real alternative to fix these problems – but what about all the situation where these banks have dealt with consumers in undesirable way and had not been sprung? Eg banks do not have a great reputation with regards to how they charge many of their fees. Other examples are Opes Prime and ANZ. Also note that Aviva has a 24% ownership of Professional Investment Services has had significant problems with both Westpoint and with the failures of Great Southern/Timbercorp. By contrast, to my knowledge, no members of the BFPPG have had any problems with Westpoint and only a tiny exposure to agricultural schemes.

    o "**Mr Cooper**—**It is how a large part of the industry is structured.** Nonetheless, because of the perimeter around that list, what it often means is that—although **the products might be all relatively the same—they are relatively safe** and the advisor understands what those products are and that there has been a sorting or weeding process. **Those products might be a little bit vanilla and some people might say that the price competition around accessing those products is not as vigorous** as it might be, but often what you will find is that **they are reasonably appropriate for the client** and that they do not have catastrophic problems."

    o "**Mr D'Aloisio**—**That is another big issue to with the notion of distribution versus advice**. You used the phrase **'independent adviser'**. Clearly, you can use the analogy of a solicitor or an accountant or some other profession that you use on a fee-for-service basis. You can conclude in those cases that the advice that you are given is free of bias, if you like, towards one product list or another. **That is a model that is in the market and it needs to be evaluated**. Working out whether that is the best or only model that can work would need a lot of other consideration. As Jeremy has just said, when you look at these product lists and how they work and you look at the reputation of the brand that might be behind them and the organization that is doing it, there is also **a lot of comfort to be drawn from the fact that those organizations, given their reputation,** have put those products on a product list, have developed them and will stand behind them. **It means that the financial planner or adviser who is recommending those products is probably in a reasonably good position from the consumer's point of view."**
- On the other hand, ASIC seems to be acknowledging that the big end of town has major conflicts of interest and that this leads to poorer advice.

    o "**Mr Cooper**—The shadow shopping work that we do shows that **where there is a conflict in the way that the adviser is remunerated or otherwise connected with the**

> **product there is a fairly strong correlation between that and advice that does not have a reasonable basis or is otherwise not up to par.** So there is data that shows there is a correlation there.

These two positions seem to be total contradictions.

The only way I can interpret ASIC position is from a natural behaviourial perspective. People have natural reactions to reward and punishment. I remember when about 5 or 6 years ago, a small Small APRA trustee named Commercial Nominees (http://www.asic.gov.au/asic/asic.nsf/byheadline/03-408+Commercial+Nominees+directors+removed+from+securities+industry?openDocument) misbehaved and some of the super funds lost money. Because it was super money, the government made up the losses – and (in effect) blamed APRA for poor supervision of the Small APRA trustee sector. APRA was kicked in the backside by the government. So APRA sought to avoid being kicked in the backside again and they did this (if I recall correctly) by increasing the capital adequacy requirements of Small APRA trustees – thus driving out of business all of the small Small APRA trustees. This was a bad result for consumers as it drove up the costs of using a Small APRA Fund considerably. We had been using the services of a Small APRA Trustee named Australian Superannuation Nominees (ASN), which provided good service at a modest cost. When Australian Superannuation Nominees was driven out of business, all ASN's Small APRA funds were transferred to the Australian Wealth Management section of Tower – where the service was appalling and not as flexible as ASN … and it was very painful extracting the clients from there … and costs were going to rise considerably. Tower Trusts standard trustee service was considerably more expensive than ASNs.

In summary, it seems to me that ASIC is arguing that consumer's would be better off if only the financial planning subsidiaries of institutions were the only source of financial planning advice – even though advice is often poor. The only logic in this seems to be that ASIC could cover its backside better – because there is less likelihood of Storm Financial or Westpoint style disasters – and so ASIC is less likely to be kicked. This therefore would be a rational behaviour that one would expect a regulator would be inclined to – not not a behaviour which would be in the best interests of consumers.

Here are some examples of financial institutions not being as pure as the driven snow.

ASIC seems to be suggesting that because of reputational risk, the institutions will do the right thing by the financial planning clients. If that was the case, why do we see examples such as those following?

In light of this sort of track record, why is it reasonable that financial planning be delivered into the hands of the institutions as ASIC seems to be indicating as its preference?

http://www.moneymanagement.com.au/article/Financial-institutions-overcharging-in-contract-fees/491263.aspx

Financial institutions overcharging in contract fees

22 July 2009 | by Amal Awad
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Financial planners would do well to advise their clients to challenge exorbitant break fees on mortgages, a specialist lawyer has warned.

Financial Redress, a Perth-based law firm specialising in recovering compensation from financial institutions for excessive charges or mis-selling, has reported an uptick in claims of unfair charging in recent months.

Managing director James Middleweek said financial institutions are making very substantial profits in fees and charges on mortgages, banking transactions and credit cards, with many customers paying in the tens of thousands.

Middleweek said banks are overcharging, with break fees having "an air of penalty" about them and also noted the often poor disclosure on break fee terms.

If, for example, a client wished to move from a fixed to a variable rate in their mortgage plan, they could be charged a "massively exorbitant" penalty, Middleweek said.

"Penalty fees are a consumer issue and financial planners should be telling their clients, I believe, that they're challengeable," Middleweek said, noting financial institutions were often charging "radical rates" and that fees could vary from week-to-week.

"People need to understand just how banks calculate these terms."

He added that unfair contract terms laws soon to be enacted will enable consumers to challenge these terms.

In terms of successful recovery of clients' money, Middleweek said some banks are "being more progressive and reasonable than others".

Financial Redress will also be casting its eye over the insurance sector in the near future.

http://money.ninemsn.com.au/article.aspx?id=843064

NAB dumps overdraft penalties after backlash

29/07/2009 6:55:14 AM
NAB

The National Australia Bank is set to dump penalty fees charged on overdrawn savings accounts after admitting that the charges have damaged the bank's reputation.

Australia's other major banks may be forced to follow suit in a bid to stay competitive, with ANZ, Westpac and CBA all currently reviewing their charges.

NAB chief executive Cameron Clyne will announce the move today in a bid to win new customers and improve the bank's image, a bank spokeswoman confirmed.

The controversial fees will disappear from personal transaction and savings accounts, including cheque accounts, from October 1, the report said.

The gesture will cost the bank $100 million a year, with no new fees planned to offset those lost by axing penalty fees.

An internal memo said the bank's image had been tarnished by penalty fees.

"These fees generate the most customer complaints of any bank fee and result in more customer complaints to us than any other matter," personal banking executive Lisa Gray told senior managers in the memo.

"We hear stories every day about a customer's pay going in a day late, gym fees or an insurance premium coming out early - the overdrawn amount is paid or not - but either way an overdrawn account fee is generated.

"Most of our customers who experience these fees just don't think it is fair."

The move is expected to put pressure on other banks to follow suit.

If a bank account becomes overdrawn, the bank may or may not process the transaction, depending on the customer, and interest will be charged on overdrawn amounts.

Speculation is now mounting over whether other banks will follow the NAB's lead.

Australia's banks, which have been labeled the world’s most expensive, earned more than $11 billion in fees from customers last year, according to the Reserve Bank of Australia (RBA).

The RBA said the 18 banks included, which represent around 90 percent of the banking sector, raked in $11.6 billion in fees in 2008, an increase of $885 million in one year.

The banks charged households $4.8 billion in fees, while businesses were hit with $6.7 billion in fees.

For the first time, the RBA tracked ‘exception fees’ in its analysis. Exception fees are the charges that banks levy when a customer breaches the terms of a product - such as making a late payment or exceeding a credit limit.

The RBA found that banks charged customers $1.2 billion in exception fees - with the majority of charges relating to credit card and deposit accounts.

While the RBA data analysed 18 banks, it is believed that around half of the $11 billion charged in fees is attributable to the big four banks.

http://www.choice.mobi/viewArticle.aspx?id=104845&catId=100385&tid=100008&p=6&title=Unfair+bank+penalty+fees

Unfair bank penalty fees

They might be called 'fees for service', 'contract fees' or 'penalty fees'. But we think some banks impose unfair or even unlawful fees on their customers.

Updated 09/08

Contents

Banks, credit unions and building societies charge fees of up to $50 when consumers exceed their credit limit, pay their credit cards one day late or fail to have sufficient funds in their account when a direct payment is due. Until June 2007 one major bank even charged consumers when somebody pays them by cheque but the cheque bounces through no fault of the customer. They recently changed their terms and conditions, possibly as a result of publicity given to the issue by CHOICE.

These fees are unfair:

* The amount of these fees bears no relation to the cost incurred by the financial institution as a result of the consumers default. For this reason they may be unlawful as well as unfair.
* Fees have been increasing far more quickly than inflation – some have gone up by 40% in two years.
* Banks could easily help consumers to avoid fees but choose not to. They could offer credit cards which can't go over the limit, or they could warn consumers that a payment is due but there are not enough funds in the account.

Bank income from fees is increasing rapidly. Some fees are legitimate, but others are nothing short of price gouging. The time has come for banks to get rid of some fees and make others fairer.

CHOICE published its first review of bank penalty fees in 2005, following a Consumer Action report into unfair bank penalty fees in December 2004.

In the UK hundreds of thousands of consumers (some say more than a million) have demanded that their bank repay unfair fees. The UK Office of Fair Trading has imposed limits on fees and is holding an ongoing investigation.

Now it's time for action in Australia!
What we want

Banks and other financial institutions should:

* Eliminate inward cheque dishonour fees.

* Introduce systems to provide a greater range of options and real-time information to consumers where there are insufficient funds to make a due payment. These might include simply declining payments without charging a fee, an automated system to notify consumers by email or text message (or perhaps for concession card holders without electronic facilities, by phone), or by automated message via the ATM or EFTPOS system, before the payment is processed.

* Adopt one of the following responses to credit card over-the-limit and account overdrawn honour fees:

    o eliminate the fees altogether (we note that credit cards operated successfully in Australia for some 20 years without such fees)

    o offer consumers a choice between declining transactions (at no cost), or charging a reasonable fee no more than the actual cost to the bank or say 2-3% of the amount by which the consumer has exceeded the limit/overdrawn their account, whichever is lower.

- Ensure that all other penalty fees are limited to the actual costs incurred by the institution.

http://www.moneymanagement.com.au/article/Bank-planner-charges-questioned/491439.aspx

Bank planner charges questioned

24 July 2009 | by Corrina Jack and Lucinda Beaman
Print this article Comments Share this article

In an environment where financial planners are under increasing pressure to justify to clients their fees and commissions, the pricing model employed by Commonwealth Financial Planning has been called into question.

Client case studies included in Commonwealth Financial Planning's pricing policy, and provided to Money Management, reveal one-off fees being paid for the implementation of advice already paid for under a Statement of Advice (SOA) fee.

Hewison & Associates chief executive John Hewison said "overcharging" of clients is one of the issues leading to the reputational damage of financial planners.

"We as an industry need to be able to be charging reasonable fees for the service we provide to clients," Hewison said.

Paul Cullen, head of Commonwealth Financial Planning Advice, defended the group's pricing structure. He said he believes the group's fees were lower than the industry average and represented value for clients.

One case study in the Commonwealth Financial Planning pricing guide (September 2008) depicts a man with $1.5 million to invest. The planner recommends $800,000 be placed in an annuity, with the remaining $700,000 invested in a FirstChoice Wholesale fund, a managed fund offered by Commonwealth Bank-owned Colonial First State.

The case study states that 'due to the complexity' of the advice given, the SOA fee would be $1,650. The adviser also charges a One-Off Adviser Service Fee of $15,000. The one-off fee is an amount charged by Commonwealth financial planners to implement the recommendations made in a client's SOA to a maximum of $15,000.

The client in the case study also signs onto an Ongoing Service Package, which results in an Ongoing Adviser Service Fee of $7,500 and a charge of 0.33 per cent of the amount invested in the FirstChoice Wholesale fund – the Compulsory Ongoing Licensee Fee.

The result for the client is a fee of $26,460 in the first year of the investment and $9,810 every year after that. This is a cost of more than $800 per month.

Hewison said while he believes the $1,650 charged for the SOA is "quite justified", he finds the $15,000 One Off Adviser Service Fee "just ludicrous".

"The notion that you should pay an upfront fee simply for filling in some forms and placing some investments just doesn't wash," he said.

Hewison also questioned the value of a client paying more than $9,000 for ongoing advice related to the management of an annuity and an investment in a wholesale fund.

"If the value is simply an annual review and reviewing some managed funds, it hardly justifies the fee," Hewison said.

According to Commonwealth Bank promotional material, the Ongoing Adviser Service Fee provides clients with a range of services including an annual review with their planner, market updates, information on new or improved financial solutions and explanations of changes to legislation and taxation rules.