IV. The Financial System: Why Bad Things Happen to Good People

So now we understand how vast amounts of money can be created out of nothing. This is not to deny that standard economics has value in some of its methodology when describing the creation of real wealth from labor and capital transforming resources into products. But an enormous financial industry has developed only to manipulate money. And the decisions of the financial system are increasingly being made by computers on the basis of esoteric mathematical formulas with the sole objective of replicating money as a pure abstraction. It is a long way from the invisible hand of the market Adam Smith had in mind. It is the reality of a world ruled by "free-market" forces. The global financial system has become a parasitic predator that lives off the flesh of its host - the productive economy.

A. The Corruption of the System

Four developments are basic to the corruption of the financial system [2]:

1. The United States financed its global expansion with dollars, many of which now show up on the balance sheets of foreign banks and foreign branches of U.S. banks. These dollars are not subject to the regulations and reserve requirements of the U.S. Federal Reserve system.

2. Computerization and globalization melded the world's financial markets into a single global system in which an individual at a computer terminal can maintain constant contact with price movements in all major markets and execute trades almost instantaneously in any or all of them. A computer can be programmed to do the same without human intervention, automatically executing transactions involving billions of dollars in fractions of a second.

   Unjust profits are those that are stolen from the rest of us by using unsymmetrical information and high frequency trading to skim those profits from the pool of investments that the rest of us are depending on. Fair economic activity depends on everyone who wants to play the stock market casino game having the same information and opportunity. How fast is your computer?

   The people making the money from stock transactions are NOT the companies creating jobs. They are predatory high frequency traders using software robots. Sixty percent of trades are now automated, using algorithms that can cause flash-crashes and liquidity crunches.

   Stock exchanges can now execute trades in less than a half a millionth of a second—more than a million times faster than the human mind can make a decision. Financial firms deploy sophisticated algorithms to battle for fractions of a cent. Designed by the physics nerds and math geniuses known as quants, these programs exploit minute movements and long-term patterns in the markets, buying a stock at $1.00 and selling it at $1.0001, for example. Do this 10,000 times a SECOND and the profits add up.

   Computer programs send and cancel orders tirelessly in a never-ending campaign to deceive and outrace each other, or sometimes just to slow each other down. They might also flood the market with bogus trade orders to throw off competitors, or stealthily liquidate a large stock position in a manner that doesn't provoke a price swing. It's a world where investing—if that's what you call buying and selling a company's stock within a matter of seconds—often comes down to how fast you can purchase or offload it, not how much the company is actually worth. These types of trades have been shown to often decrease a company’s value – on purpose.

3. Investment decisions that were once made by many individuals are now concentrated in the hands of a relatively small number of professional investment managers under enormous competitive pressures to yield nearly instant financial gains. The pool of investment funds controlled by mutual funds doubled in three years to total $2 trillion at the end of June 1994, as individual investors placed their savings in professionally managed investment pools rather than buying and holding individual stocks. Meanwhile, there has been a massive consolidation of the banking industry - more than 500 U.S. banks merged or closed between September 1992 and September 1993 alone - concentrating control of huge pools of funds within the major international "money center" banks. Pension funds, now estimated to total more than $3 trillion in assets, are managed mostly by trust departments of these giant banks, adding enormously to their financial power. The pension funds alone account for the holdings of about a third of all corporate equities (stocks) and about 40 percent of corporate bonds.

4. Investment horizons have shortened dramatically. The managers of these investment pools compete for investors' funds based on the returns they are able to generate. Mutual fund results are published on a daily basis in the world's leading newspapers, and countless services compare fund performance on a monthly and yearly basis. Individual investors have the ability to switch money among mutual funds with the push of a button on an electronic phone or with their personal computers on the basis of these results. *For the mutual fund manager, the short term is a day or less and the long term is perhaps a month*. The time frames involved are far too short for a productive investment to mature, the amount of money to be "invested" far exceeds the number of productive investment opportunities available, and the returns the market has come to expect exceed what most productive investments are able to yield even over a period of years. Consequently, *the financial markets have largely abandoned productive investment in favor of extractive investment* and are operating on autopilot without regard to human consequences.

The financial system increasingly functions as a world apart at a scale that dwarfs by orders of magnitude the productive sector of the global economy, which itself functions increasingly at the mercy of the massive waves of money that the money game players move around the world with split-second abandon. Joel Kurtzman, formerly business editor of the *New York Times* and currently editor of the *Harvard Business Review,* estimates that *for every $1 circulating in the productive world economy, $20 to $50 circulates in the economy of pure finance* - though no one knows the ratios for sure. In the international currency markets alone, some $800 billion to $1 trillion changes hands each day, far in excess of the $20 billion to $25 billion required to cover daily trade in goods and services. According to Kurtzman [2]:

> “Most of the $800 billion in currency that is traded...goes for very short-term speculative investments - from a few hours to a few days to a maximum of a few weeks... That money is mostly involved in nothing more than making money... It is money enough to purchase outright the nine biggest corporations in Japan - overvalued though they are - including Nippon Telegraph & Telephone, Japan's seven largest banks, and Toyota Moto... It goes for options trading, stock speculation, and trade in interest rates. It also goes for short-term financial arbitrage transactions where an investor buys a product such as bonds or currencies on one exchange in the hopes of selling it at a profit on another exchange, *sometimes simultaneously* by using electronics.”

This money is unassociated with any real value. Yet the money managers who carry out the millions of high-speed, short-term transactions stake their reputations and careers on making that money grow at a rate greater than the prevailing rate of interest. This growth depends on the ability of the system to endlessly increase the amount of money circulating in the financial economy, independent of any increase in the output of real goods and services.

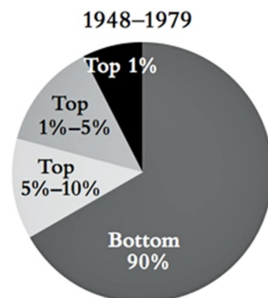
Individuals may be able to set aside money for the future, but not a society as a whole; a society guarantees its future only by real physical and social investments. But the financial markets are demanding cutbacks in both public and private investment in the name of "financial prudence.” The whole idea of creating huge pools of financial capital should be the focus of attack, not the uses to which these pools are put.

"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

"We can surely eat lower on the food chain, but we cannot eat recipes."
Herman Daly

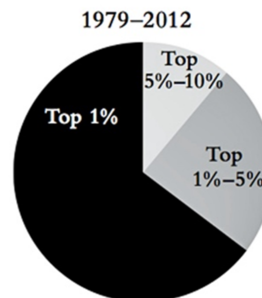
THE INCOME GROWTH BETWEEN 1979 AND 2012 HAS GONE TO THE TOP 10%

1948–1979



33% of growth went to richest 10%.
67% of growth went to bottom 90%.

1979–2012



All growth went to richest 10%.
Income of the bottom 90% declined.

Source: Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913–1998," *Quarterly Journal of Economics*, February 2003; updated to 2012 by Emmanuel Saez and available at http://elsa.berkeley.edu/users/saez.

B. So Who Really Owns the Money?

Some of the best data to answer this question has been published by United for a Fair Economy in Shifting Fortunes: The Perils of the Growing American Wage Gap [8]:

> "In the past, egalitarian democracy has been coupled with inegalitarian capitalism on the assumption that government would do three things. First, government guaranteed that first-class educations and skills would be available to children of parents who did not have first-class income and wealth. The next generation would be better skilled and able to earn more than the last. Second, it would insure that those who cannot compete for whatever reason do not get driven into economic or physical extinction (hence the social safety net). Third, government would use the tax system to make after-tax distributions of income and wealth more equal than before-tax distributions of income and wealth. For the last two decades, the American government has been backing away from all three of those commitments.
>
> Behind the hoopla of the booming 1990s and early 2000s, most Americans have actually lost wealth. Most households have lower net worth (assets minus debt) than they did in 1983, when the stock market began its record-breaking climb. From 1983 to 1998, the stock market grew a cumulative 1,336 per-cent. The wealthiest households reaped most of the gains.
>
> The top 1 percent of households have soared while most Americans have been working harder to stay in place, if they have not fallen further behind. Since the 1970s, the top 1 percent of households have doubled their share of the national wealth at the expense of everyone else. Using data from the Federal Reserve Survey of Consumer Finances, economist Edward Wolff of New York University says that the top 1 percent had 40 percent of the nation's household wealth as of 1997. The top 1 percent of households have more wealth than the entire bottom 95 percent.
>
> Financial wealth is even more concentrated. The top 1 percent of households have nearly half of all financial wealth (net worth minus net equity in owner-occupied housing). Wealth is further concentrated at the top of the top 1 percent. The richest 1/2 percent of households have 42 percent of the financial wealth.

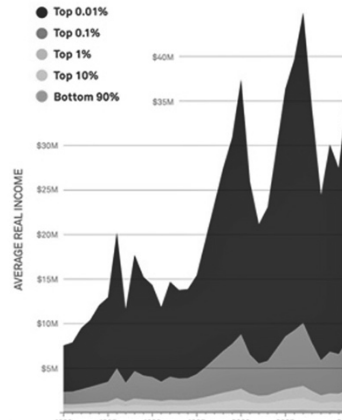
Statistics from Henwood [9], show that:

> "Ownership of financial assets like stocks and bonds is densely packed in the upper crust. In 1992, the *richest 1%* of households - about 2 million adults - *owned 39% of the stock* owned by individuals, and *42% of the bonds*. *The top 10% together own well over 80% of both*.
> Those numbers are based on sorting households by their net worth; if you sort households by their stock ownership, the concentration is even more intense. In 1992, the top 0.5% of stockowners held 58.6% of all publicly traded stock; the next 0.5%, 11.7%; the next 4%, 24.2%; add those together and you discover that ***the top 5% owns 94.5% of all stock held by individuals***. Despite myths of affirmative action and upward mobility, the tendency of wealth to concentrate, for advantage to breed advantage, makes it hard on people who start with nothing."

The recession left the middle class treading water. But it's been smooth sailing for the 1 percent.

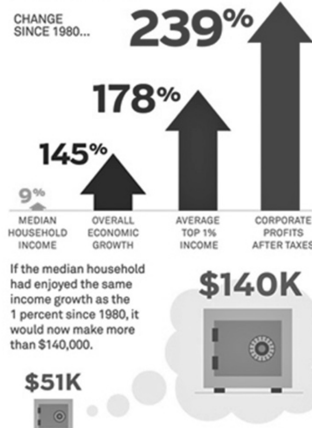
THE RICH AND THE MEGARICH

Since 1980, the average real income of the 1 percent has shot up more than 175 percent, while the bottom 90 percent's real income didn't budge. But as this chart shows, the vast majority of gains have gone to the tippy-top.



WORKING MORE, EARNING LESS

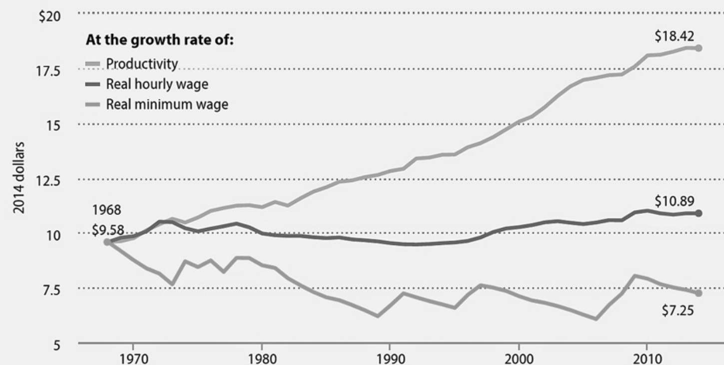
You're working harder than ever, but you're still treading water. In 2012, the median household income had dropped to where it was in 1996 (adjusted for inflation).



http://www.motherjones.com/politics/2014/10/charts-income-inequality-recession-survival-richest

The minimum wage would be over $18 had it risen along with productivity

Real value of the federal minimum wage compared with its value had it grown at the rate of productivity and average hourly wages, 1968–2014



Note: Real average hourly wages are of production/nonsupervisory workers in the private sector, and productivity is net productivity of the total economy.

Source: EPI analysis of data from the U.S. Department of Labor's Bureau of Labor Statistics and Labor Wage and Hour Division

Adapted from Figure A in *Raising the Federal Minimum Wage to $10.10 Would Save Safety Net Programs Billions and Help Ensure Businesses Are Doing Their Fair Share*

C. Stratos Dwellers: The Global Overprivileged

David Korten calls the extremely wealthy of the world the Stratos Dwellers, those global overprivileged who are disconnected from the reality of real people [2]:

> "Of any country I have visited, Pakistan most starkly exemplifies the experience of elites living in enclaves detached from local roots. The country's three modern cities - Karachi, Lahore, and Islamabad - feature enclaves of five-star hotels, modern shopping malls, and posh residential areas within a poor and feudalistic countryside governed by local lords who support private armies with profits from a thriving drug and arms trade and are inclined to kill any central government official who dares to enter. Health and education indicators for Pakistan's rural areas are comparable to those for the most deprived African nations.

On two of my visits to Pakistan, I was the guest of some of the country's most successful businessmen. Widely traveled and graduates of the best British and American universities, they spoke and moved with the confidence, demeanor; and sense of hospitality typical of cosmopolitan aristocrats who are fully at ease with their money and position. My hosts regularly traveled the world to supervise their widespread business interests, moving easily among the global business elites and feeling as much at home in New York or London as in Karachi, Lahore, or Islamabad.

Particularly striking, however, was the extent to which - in contrast to their knowledge of and interest in the rest of the world - they had little knowledge of or interest in what was happening in their own country beyond the borders of their enclave cities. It was as though the rest of Pakistan were an inconsequential foreign country unworthy of notice or mention. They were almost completely detached from any sense of national interest. What I failed to realize at the time was that this phenomenon was not an aberration of underdevelopment so much as the cutting edge of a global social and political trend - a melding of the world's financial elites into a stateless community in the clouds, detached from the world in which the vast majority of ordinary mortals live."

We have long thought of the world as divided into rich and poor countries. As economic globalization progresses, we find growing islands of great wealth in poor countries and growing seas of poverty in rich countries. President Clinton's former Secretary of Labor, Robert Reich, has drawn a disturbing American portrait in which privileged information/communication workers increasingly withdraw public support from the larger society. His grim analysis portrays them moving to insular suburbs and buying private recreational, schooling, security and sanitation services for their own gated communities, which the public at large cannot afford. They are then positioned to refuse to pay taxes for the declining public services they no longer need. Their withdrawal (Reich labels it the politics of secession) leaves the poor poorer; the public sector broke, and society ever more riven by economic disparities. A similar pattern of "secession" by the new symbolic elites can be discerned on a global scale where elite nations secede from their global public responsibilities as fast as elite professionals secede from their public responsibilities within elite nations. The Third World becomes a series of urban ghettos within every First World society as well as a series of poor nation ghettos within international society.

The isolation of the rich and powerful is exemplified by the annual gathering of the directors of the World Bank and the International Monetary Fund (IMF). The following is an account by journalist Graham Hancock from one such meeting [2]:

"I had come to Washington, D.C. simply to attend the joint annual meeting of the Boards of Governors of the World Bank and the International Monetary Fund - two institutions that play a central role in mobilizing and disbursing funds for impoverished developing countries. The total cost of the 700 social events laid on for delegates during that single week was estimated it $10 million. A single formal dinner catered by Ridgewells cost $200 per person. Guests began with crab cakes, caviar, smoked salmon and mini beef Wellingtons. The fish course was lobster with corn rounds followed by citrus sorbet. The *entree* was duck with lime sauce, served with artichoke bottoms filled with baby carrots. A hearts of palm salad was also offered accompanied by sage cheese soufflés with a port wine dressing. Dessert was a German chocolate turnip sauced with raspberry coulis, ice-cream bonbons and flaming coffee royale. Washington limousine companies were doing a roaring trade."

If the delegates had indeed made an effort to look at their world through the eyes of the most underprivileged, they might well have lost their appetites. Take, for example, this simple interview with a sharecropper's child in nearby Selma, Alabama, by Raymond Whetter of CBS TV [2]:

"Do you eat breakfast before school?"
"Sometimes, sir. Sometimes I have peas."
"And when you get to school, do you eat?"

“No, sir.”
“Isn't there any food there?”
“Yes, sir.”
“Why don't you have it?”
“I don't have the 35 cents.”
“What do you do while the other children eat lunch?”
“I just sits there on the side” (his voice breaking)
“How do you feel when you see the other children eating?”
“I feel ashamed” (crying).

D. Stock Market Myths

I want to focus on the stock market in a bit more detail because it is a major driving force in the way corporations behave. Breaking through the myths fed to the general public by the financial media can bring a revelation akin to that of an old time Catholic who finally realized he wouldn’t go to hell for eating meat on Friday!

The stock market is not the hub of capitalism, as some believe. In fact trading in bonds and foreign exchange dwarfs stock market trading. There are three alleged purposes for the stock market. The first is that it provides a way for some new companies to raise large amounts of capital. The second is that it provides an additional source of capital, if needed, after a company has gone public, through a secondary issue of stock into the marketplace. And third, it provides a measure of the “market value” of a company when one company decides to buy another, through an acquisition or merger.

In the first case, a company basically sells its soul in an initial public offering (IPO). This is the process of “going public.” It raises millions of dollars with the benefit of not having to pay the money back to anyone – it’s not a loan. But going public does affect the soul of the company because everything the company now does must be done in public under the scrutiny of the government and the shareholders. This is not necessarily good. The simplest example of the negative aspect of being a public company is that the managers of a private company have the freedom to make rational decisions. They can decide to lower their profit margin - to invest in new people or equipment or to avoid a layoff, for example - without causing any impact on an arbitrary stock price. I have been in situations where we did just that.

The real incentive to go public is the large amounts of money the financial backers and each employee of the company, not just the managers, can make because of their stock options. The goal of most new startup companies is to go public for that reason, and the case can be made that it creates very strong incentives for the employees to work diligently to make the company a success. But when big money is the ultimate goal, the law of unintended consequences often bares its fangs

The case of the secondary stock offering is simple – more stock sold in the public market equals more money in the company’s bank account. But it obviously drives the company to keep the stock price high now if it plans to sell more stock later. The third purpose, providing an objective value of a company, has some relative validity in the way the game is played today. But is not the only, nor necessarily the best, mechanism for that valuation. Consider Internet company stocks in 1999, for example. But none of the three purposes discussed above leads to significant financial activity compared to the vast amounts of money traded daily in the stock market. What no one wants you to know, and what only a small percentage of people understand, is that the stock market is nothing more than a big gambling casino with the large financial companies as primary owners, fund mangers as the dealers, and stock analysts as the lounge singers. Large and small investors wander among the various game tables with the only real difference being the cash needed to bankroll one of the games. In the broadest sense, the stock market provides no real productive value to an economy.

1. Stocks Support Company Growth – Not!

Both civilians and professional apologists would probably say that the stock market raises capital for investment. *In fact it doesn't*. Per Henwood [9], between 1981 and early 1996, U.S. nonfinancial corporations retired over $700 billion more in stock than they issued, thanks to takeovers and buybacks. Most of the daily trading in the stock market is of *existing* shares, not newly issued ones. Over the long haul, almost all corporate capital expenditures are internally financed, through profits and depreciation allowances. Of course, some individual firms do issue stock to raise money, but surprisingly little of that goes to real investment either. The process we all hear about is an Initial Public Offering (IPO). However, once the IPO takes place, the stock, mostly "common stock" which often pays no dividends if the company is small, is traded in the "secondary" stock market (98% of NYSE and almost all of NASDAQ is common stock). *This means that the stock is traded among individuals with no real connection to the original company*.

I was a senior manager in a startup telecommunications company that went through an IPO. I have to admit that I felt the power of the dark side of that abstract *Homo economicus*. After almost four years of intensely hard work (often 10 hour days, 6 day weeks), every employee stood to make a lot of money, and many would become quite wealthy (a couple of dozen millionaires), at least on paper.

A company doesn't sell its stock on the open stock market. In reality, a consortium of investment banking and brokerage firms (the underwriters) helps determine the amount of stock and the guaranteed initial price of the stock to be offered (called "taking the company public"). The underwriters then buy the stock from the company at the guaranteed IPO price (for example, 5 million shares at $25 per share for $125 million to the company). Once that happens the company, as a company, has no more special ownership of the stock – it has the money in the bank. But individual employees in the company, especially senior management, with thousands or tens of thousands of stock option shares (each at a cost anywhere from a nickel to a dollar a share), have an extremely keen personal interest in the outcome of the IPO. The final price in the market is what they will get for their shares when they are finally able to sell them (usually over a four-year vesting period).

Take a real life example. An engineer who joins a startup company may get an option for 5,000 shares at $0.05 per share. He or she works incredibly hard for 3 or 4 years (Thanksgiving, Christmas, and Easter holidays included). The stock splits once before the IPO and once after the IPO. Our engineer now has 20,000 shares at $0.0125 per share. In the boom times the stock is at $42 per share and the engineer is looking at $840,000 profit, before taxes. (However, if the stock crashes to $4 per share, as this one did less than two years later, the profit drops to only $80,000.) Perform the same calculation for a senior manager who joined the company at the same time as the engineer but got an original option for 20,000 shares! Even assembly workers and test technicians received stock options worth tens of thousands of dollars. Many people bought new cars for cash after the IPO. Although not as extreme, normal profit sharing and stock option plans in established companies can also be very strong incentives to drive up profits and stock prices at all costs, especially for top management.

The original underwriters also has a deep interest in the IPO because they were the ones who actually paid the initial price and will only make a profit if the price of the shares increases (for example, to $35 per share, for a $50 million profit on the original five million shares) as they are sold into the open stock market. Of course, the members of this investment group are also usually members of the initial capital financing of the IPO company and so may also own millions of low-priced stock option shares from their initial investment in the startup. For example, if the IPO is for five million shares, there may be an additional thirty million shares, at an average cost of $1, in the hands of employees and the financial backers. (Exercise: multiply thirty million by $35.) Although the company makes a significant amount of money in the initial round, the large financial market players are the big winners in the game.

How the IPO stock is initially priced is somewhat esoteric, but is based on the company's multi-year plan for revenue and profit growth. The more rapid the revenue and profit growth projected over the following three to five years, the higher the IPO price. In our case, the revenue and profit projections were so

“aggressive” that it would be extremely difficult to grow the company as fast as the plan required - *doubling* in size every year for several years - which is known in the trade as a “stretch objective” or BHAG (Big, Hairy Audacious Goal). Therefore, the employees of the company, including the managers, were trapped in a multiyear business plan primarily driven by the stock price desires of the large financial corporations, even though abetted by their own personal desires.

To be fair, we all took part in the planning process, and we knew it would be tough. However, aside from the “rah-rah” of how much better we were than the competition, of how well we could meet the “challenge” of an “aggressive growth plan”, of exciting and interesting career opportunities for all employees, the final driving force which shaped all “reality” was the stock price and how much money everyone personally would make over a relatively short time frame. The stock price did increase beyond our wildest dreams, but wild dreams can lead to wild actions. Working all night for days is common near the end of a quarter. To guarantee high revenues, there were times the V.P. of Engineering tested circuit boards in the Test Department, and the CEO helped pack boxes in the Shipping Department. And it wasn’t because of egalitarianism or because the customer necessarily needed the product. Customers were often asked to accept shipments early so the quarterly numbers could be met. This type of activity is not unique in the corporate world.

This is one example of how the short term profit requirements of financial markets control even relatively environmentally benign telecommunications companies, including the intelligent and usually socially-conscious people in those corporations. It gives an insight into the forces driving extractive industries like lumber and mining or the cultural-imperialist corporations of fast food and fashion.

2. The Small Investor: Gambler/Sucker/Believer (Choose One)

Despite the stories about delivery drivers getting rich off stocks traded online, the boom has bypassed most Americans. As of 2015, as a previous chart showed, 40 percent of households owned stock directly and indirectly - including through a mutual fund, individual retirement account and defined contribution pension plan, for example. This is a significant increase from 32 percent in 1989, but still less than half of all households.

A growing number of Americans own stock, but most still don't own much. Less than one-third of households (29 percent) owned stock worth more than $5,000 in 1995. Almost 90 percent of the value of all stocks and mutual funds owned by households was in the hands of the top 10 percent. Wealth projections through 1997 suggest that 86 percent of the benefits of the increase in the stock market between 1989 and 1997 went to the richest 10 percent of households, with 42 percent going to the top 1 percent alone.

But what drives individual stocks? Again, especially since it’s a casino, it’s simply a perception of a company or industry segment. If I think a stock will go up because I think other people will think it will go up, I buy now. When it does goes up, I sell, take my profits, and look for something else I think will go up. If it goes down, I sell, take my losses against my income tax, and look for something else I think will go up. Since it’s so simple, a ritual has grown up around this activity to make it seem complex, scientific, or logical. The mythmakers will say that a company has a value based on its future revenues and profits. This is called determining the “market fundamentals” of a company. (Even George Soros [14] points out that market fundamentals are no longer meaningful – Internet stocks again.)

Through “analysis” the “professionals” will judge the future sales projections in a company’s “target market”, their potential profitability based on their “efficiency”, the capability of their “management team” to meet their plan, and peg a stock price. Any stock price is essentially arbitrary. The final driver for the stock to go up or down over time is primarily the change in short term profitability of the company which drives the herd mentality of the market players.

So why do normal people invest in the stock market? Many have no choice since their pension funds and 401K money is invested in stocks but not controlled by them. For others with a choice, it’s not just raw greed, but a “reasonable” desire to have more. If others have done it, why can’t I? But there are risks. Say

you have $10,000 in a CD at 5%, you make $500 interest in a year with no risk. With a CD from a bank you actually get the $500 deposited in your bank account at the end of the year, as well as your principal back, for a new total of $10,500. Then you can decide to buy another CD or not.

But the financial media tell you that only conservative little old ladies own CDs and you can get twice the return by buying stock. If you buy 500 shares of some stock selling at $20 per share, you've now fully invested your $10,000. If you're lucky, the stock goes up $2 (or 10%) during the year and you "make" $1,000 (instead of the CD's $500). But remember you only get the money if you now sell the stock. And typical stocks are notorious for movements of several dollars at a time. At the end of the year the stock may just as likely be selling for only $18 per share and your original investment is now down to only $9,000. You lost $1,000 by trying to make an additional $500. Some gamble if you really need your money! Mutual funds do limit your risk by spreading it over many more stocks, but the principle is the same.

E. Financial Cannibals: The Headwaters Example

"Is it progress," the Polish poet Stanislaw Lec asked, "if a cannibal uses a fork?" Finding ways to create new value in a sophisticated modern economy is seldom easy. Finding ways to create new value that will produce returns in the amount and with the speed demanded by a predatory financial system many times larger than the productive economy is virtually impossible. The quickest way to make the kind of profit the system demands is to capture and cannibalize existing values from a weaker market player. In a free market, the "weaker" player is often the firm that is committed to investing in the future; providing employees with secure, well-paying jobs; paying a fair share of local taxes; paying into a fully funded retirement trust fund; managing environmental resources responsibly; and otherwise managing for the long-term human interest. Such companies are a valuable community asset, and in a healthy economy, they pay their shareholders solid and reliable - but not extravagant - dividends over the long term. They do not, however, yield the instant shareholder gains that computerized trading portfolios demand.

It is all played out with a chilling sense of moral detachment. In the words of Dennis Levine, a Wall Street high-flyer who was imprisoned for insider trading [9]:

> "We had a phenomenal enterprise going on Wall Street, and it was easy to forget that the billions of dollars we threw around had any material impact upon the jobs and, thus, the daily lives of millions of Americans. All too often the Street seemed to be a giant Monopoly board, and this game-like attitude was clearly evident in our terminology. When a company was identified as an acquisition target, we declared that it was "in play." We designated the playing pieces and strategies in whimsical terms: white knight, target, shark repellent, the Pac-Man defense, poison pill, greenmail, the golden parachute. Keeping a scorecard was easy - the winner was the one who finalized the most deals and took home the most money."

The acquisition of the Pacific Lumber Company and its holdings of ancient redwoods on the California coast exemplify what all too often happens after an acquisition is complete by corporate raider Charles Hurwitz. Before Hurwitz acquired it in a hostile takeover, the family-run Pacific Lumber Company was known as one of the most economically and environmentally sound timber companies in the United States. It was exemplary in its pioneering development and use of sustainable logging practices on its substantial holdings of ancient redwood timber stands, was generous in the benefits it provided to its employees, overfunded its pension fund to ensure that it could meet its commitments, and maintained a no-layoffs policy even during downturns in the timber market. These practices made it a prime takeover target.

After establishing control of the company, Hurwitz immediately doubled the cutting rate of the company's thousand-year-old trees. According to *Time,* "In 1990 the company reamed a broad, mile-and-a-half corridor into the middle of the Headwaters forest and called it, with a wink and a snicker, 'our wildlife-biologist study trail.'" On a visit to Pacific's mills at Scotia, Hurwitz told the employees, "There's a story about the golden rule. He who has the gold rules." With that pronouncement, he drained $55 million from the company's $93 million pension fund. The remaining $38 million was invested in annuities of the

Executive Life Insurance Company, which had financed the junk bonds used to make the purchase – and which subsequently failed. And he was able to blackmail hundreds of millions of dollars from the government, which bought a small part of his overall holdings.

F. Socially Responsible Investing: An Oxymoron?

People who have amassed large fortunes through hard work or inheritance can, and should, make a significant contribution to society. Many do – Ted Turner, Bill Gates, and George Soros are prime examples. There's even an organization named Responsible Wealth whose brochure states that: "We are business leaders and wealthy individuals, among the top five percent of income earners and asset holders in the U.S. We are concerned about the rise in powers of large corporations and the growing gap between the rich and everyone else." My boss of many years, one of the finest human beings I've ever met, started a family charitable foundation and supports many social organizations. One day he was complaining about how complex his personal finances had become and I chided him that he just had too much money! He agreed, but pointed out that if he didn't make it and use it for good, someone else would make it and waste it. I wonder what Donald Trump's answer to that question would be? (Authors note: This was written in 2000.)

But besides contributing to volunteer organizations, what can the more modestly financially comfortable do with their money? Socially responsible investing has its historical roots in the battle to end apartheid in South Africa. Initially, a few stock mutual funds had refused to invest in companies which dealt with South Africa. In 1982 a social investment fund was set up within the Calvert Investment Group. It was the first stock fund that tried to *screen* companies to avoid bad corporate practices generally. Over the years, the search for a list of guidelines to judge whether a company was socially responsible has evolved into the present Coalition for Environmentally Responsible Economies (CERES) principles discussed later.

1. Socially Responsible Mutual Funds: A Moral Niche Market

Socially responsible investing is often promoted to the conscience-stricken. But is it really possible based on what we've seen above? Remember, mutual funds are just pools of company common stock; and they are pools in a secondary market which has minimal effect on the operation of companies themselves. (Most bonds are also traded on secondary markets.) And do the companies really care who owns their stocks or bonds? Will they become more environmentally-friendly if they know one or the other of several ostensibly socially-responsible mutual funds owns the stock? This has not been the case to date.

The 1998 annual report of Becton-Dickinson, a major health care products company, for example, shows that during the last five years they *have bought back* 50 million of their 300 million outstanding shares (how much influence do your 1,000 shares have?). It's 1998 net income was $237 million on revenue of $3.1 billion – a very respectable 7.6%. It paid a dividend of $0.29 per share, or $7.6 million (3.2% of their profit). Cash from operations continued to be it's primary source of funds to finance operating needs and capital expenditures. It also sells commercial paper and bonds as well as has at least $600,000 in lines of credit (that were not being used as of the date of the report!). Why would it really care about the stock market or its stock price? One major reason is that managers are judged professionally based on how well they influence stock price and shareholder value. But the most direct reason is because managers with stock options obviously want to sell at the highest price. The company has about 30 million stock option shares outstanding to employees, managers, and directors at an average price of $18.22. As of this writing their stock price was $38 per share – quite an incentive.

Screening sets the context for almost all social investing strategies. The goal of social investing, on the screening side, is to one day make screening a company out of a fund a punishment so high that irresponsible companies' stock prices would get pushed lower, and screening a company into a fund a reward such that responsible companies' stock prices would sell at a premium. Screening has created an industry of social investment managers and research firms who are creating the infrastructure to continually advance the state

of the art for evaluating companies, analyzing companies, asking them questions every year, putting the information on databases for the public, and trying to help everybody figure out, based on the information, how to make their investment decisions. Screening establishes a set of researchers, analysts, and investors who evaluate a company on its social and environmental performance. They are there year in and year out. They don't go away. This creates higher expectations for corporate behavior and pushes companies to be better corporate citizens. Screening sets the context that makes shareholder advocacy possible in a number of different ways. Almost all of the major money managers who do screening engage in some level of advocacy to try to improve the companies they hold.

So, what is the really socially responsible investor to do? And there's the catchword, "do." To have an impact you must be active, not passive (with a passively clear conscience because you read the prospectus from the mutual fund). If you own stock you can attend a stockholders meeting. If you own enough stock, you can make public proposals to be voted on at the stockholders meeting. Even if you don't own stock you can take actions (boycotts, protests) that are designed to drive stock prices down, thus affecting management decisions. Shareholder advocacy is an important strategy for people who hold stock in companies they're locked into, either on an individual level because of tax considerations, or on an institutional level because of the policy of the investment committee, or maybe on a pension plan level because the Employee Retirement Individual Security Act (ERISA) requirements don't allow them to divest certain kinds of companies.

2. Alternative Investment Strategies?

This is a difficult problem in the modern financial arena. There are "alternative" financial institutions, such as community development banks (CDB) and loan funds. The most prominent CDB is the South Shore Bank of Chicago whose promoters say it has revived a declining urban neighborhood while turning in a sterling financial performance. It is held up as a model for the free-market era, a private-sector alternative to "discredited" old social programs. Another is the Vermont National Bank. South Shore Bank has also supported a new fund in the Pacific Northwest to make loans to environmentally-oriented small businesses.

Community Development Funds also accept money from socially minded investors to make loans to fund housing rehabilitation, nonprofit housing development, and small businesses. Although the industry is quite small ($108 million in outstanding loans as of 1995), it has had relatively impressive effects on housing and job growth, as well as a loan loss experience of only 0.92%.

For investors with significant amounts of capital, there are venture capitalist groups such as Social Venture Network and Investors Circle which specialize in funding socially-responsible startup companies that are developing environmentally-oriented new technologies or environmentally-friendly small businesses.