The Biggest Personal Finance Story of the Past 30 Years - Conclusion

Category : Are Your Best Interests the Same as the Financial Services Industry?
Published by The Skilled Investor on Aug/21/2007

The Biggest Personal Finance Story of the Past 30 Years - ConclusionThis article concludes our series on the greatest personal finance story of the past thirty years. In this article, we discuss whether the dramatic growth in equity value of the financial services sector indicates that securities markets are becoming less efficient.Some might look at the financial services sector's current 21% share of S&P 500 market capitalization and assume that the securities markets are "not efficient." This is not necessarily the case. A far more compelling argument is that much of this growth results from a wealth transfer from individuals to the industry.
For a graph of the relative percentage shares of various sectors within the S&P500 index over five decades, see Figure 4 on page 16 of the financial study by Jeremy Siegel and Jeremy Schwartz entitled: "The Long-term Returns on the Original S&P 500 Firms." [Note that this is an Adobe Acrobat document on The Wharton School of Business website at the University of Pennsylvania. Be patient and let it load.]With the securities markets, excessive costs paid by investors can simply be a wealth transfer to financial securities firms. The concept of an efficiently priced securities market, does not tell you who will actually get to keep the market's return. If you agree to pay higher visible costs or you pay higher hidden costs unwittingly, the market's return simply ends up in someone else's pocket. Higher costs charged to individual investors just move money from one pocket to another. Retail investors are just another financial industry profit center where the client generally lacks knowledge and sophistication and pays through the nose for this lack of financial skill. (See these related articles on *The Skilled Investor* website: Controlling Investment Costs)"Market efficiency" is a concept related to whether the securities markets set appropriate risk-adjusted asset prices given all the uncertainties about future asset market values. If securities market prices are set efficiently, there should not be any investment strategies available that would produce returns that are disproportionate to the risk incurred.
While there is a very large random element associated with the volatility of individual stocks, market segments, and markets overall, the key test is whether these positive and negative statistical pricing "errors" cancel each other out over time. Securities markets are judged to be relatively efficient when current prices generally provide a relative return or risk premium over time that is commensurate with the risk taken as measured by relative volatility. Some investors may do better or worse due to randomness and luck, but efficient market pricing would not provide skilled investors with consistent, long-term opportunities to obtain higher returns without taking higher risks. (See these related articles on *The Skilled Investor* website: Securities Valuation and Returns and Risk Premiums)The finance literature endlessly debates market efficiency and statistical "anomolies" that might seem to contradict this theory. Nevertheless, the scientific finance literature indicates that the securities markets are largely "efficient" and that the markets have probably grown even more so during the past several decades. While there could be certain strategies to exploit to achieve disproportionate returns for the risk exposure, such opportunities would tend to be narrow, infrequent, transitory, and require the skills and resources of professionals to identify and exploit. Success eludes almost all individual investors in beating the market consistently over the long-run. Furthermore, success in consistently beating the market also eludes the vast majority of professional investors, as well. (See this category of articles on *The Skilled Investor* website: Luck versus Skill)Individual investors are constrained by excessively high investment costs, personal investment taxes, lack of time, lack of

knowledge, and lack of sophisticated analytical resources. In practical terms, the average individual investor can just assume that securities market prices are efficient. For individual investors, the logic of adopting a very-low cost passive index investment strategy is very compelling, because investment costs and taxes are among the few very significant investment factors that they actually can control. (See these categories of articles on *The Skilled Investor* website: Financial Decision Rules, Selecting Investment Funds, and Personal Efficiency) Therefore, 1) if securities markets are relatively efficient, 2) if individual investors are confused and highly unlikely to beat the markets and 3) if professionals also have a tough time beating the markets, then what strategies could the financial services industry adopt to increase their profits? Well, if getting a higher return from the market is not easy, taking away the investment assets of naive individual investors through excessive costs and fees can be a far easier path to higher profits. Furthermore, if investors are charged fees as a percent of their assets rather than a percent of their returns, then the individual investor does not even need to have a positive market return for the industry to get paid! One way or another, huge amounts of personal money are being poured into the financial sector by individuals and much less than what they pour in comes back to them. The choice is yours as to whether you want to keep pouring in your money or whether you want to adopt a lower cost personal finance strategy. (See these related articles on *The Skilled Investor* website: The heavy burden of recurring investment fees and The investment industry is not your investment partner)Postscript about the impact of financial company IPOs and mergers:
Note that another factor may have also contributed to the escalating value of the financial sector in the S&P500 index over the past thirty years. Some financial firms and investment banks previously may have been private entities that went public and became available to be included in the S&P 500 index. Other financial firms may have been private entities, which were acquired by public financial companies. The Standard and Poors Index Committee periodically changes the composition of the S&P 500 index in an effort to include the largest U.S. firms. If very large financial firms come to market via IPO and/or are merged into other financial firms, they become candidates for inclusion in the index. While such IPOs or acquisitions can distort the historical growth rate of the financial sector, the absolute size of the financial sector is the greatest concern and the best measure of the expected value of the ongoing wealth transfer from individuals to the industry. The revenue size, profitability, and growth of the financial sector all reinforce concerns about excessive industry costs and wealth transfer from individuals to the financial sector.