Urban Bäckström: The importance of a well-functioning stock market

Remarks by Mr Urban Bäckström, Governor of Sveriges Riksbank, at the World Federation of Investors 20th World Congress, Stockholm, 7 June 2002.

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First I want to express my gratitude for the invitation to attend your congress and briefly discuss with you the importance of a well-functioning stock market.

Let me start by saying that just as it is important that networks for transport, electricity and telecommunications function properly, so is it essential that, for example, payments can be transacted, capital can be saved and channelled to the most profitable investment projects and that both households and firms get help in handling financial uncertainty and risk as well as possibilities of spreading consumption over time. Financial markets constitute an important part of the total infrastructure for every economy that has passed the stage of domestic production.

The financial system performs three main tasks: firstly, it handles payments; secondly, it channels savings to investments with a good return for future consumption; and thirdly, it spreads and reduces economic risks in relation to the players' required returns.

A smooth functioning of all these activities facilitates economic growth in that lower costs and risks promote the production of goods and services as well as employment. In this way the financial system contributes to increased prosperity.

The stock market is one of the most important sources for companies to raise money. Experience has taught us that the price of shares and other assets is an important part of the dynamics of economic growth. Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, central banks tend to keep an Argus eye on the development of the stock market and reflect on how the financial system functions. Another reason is the oversight of financial stability.

Today, I would like to confine my brief remarks to some aspects that have to do with the fact that shares now weigh considerably more heavily in household portfolios than was the case thirty years ago. What are the implications of this trend?

Increased interest in stock market investment

In recent decades the financial system in most western countries has undergone a remarkable transformation. One feature of this development is disintermediation. A portion of the funds involved in saving and financing flows directly to the financial markets instead of being routed via banks' traditional lending and deposit operations. The general public's heightened interest in investing in the stock market, either directly or through mutual funds, has been an important component of this process. Statistics show that in recent decades shares have made up an increasingly large proportion of households' financial assets in many countries. Thirty years ago in Sweden, bank deposits and other very liquid assets with little risk made up almost 60 per cent of households' financial wealth, as against less than 20 per cent today. The major part of this adjustment in financial portfolios has gone to shares but a good deal now takes the form of insurance saving. The trend towards forms of saving with a higher risk has been accentuated by new rules for insurance companies, permitting a high proportion of shares, although this is arranged more indirectly. Similar tendencies are to be found in other industrialised countries. So it is not just in Sweden that saving has moved away from traditional bank deposits.

This is a positive trend. However, long-term saving requires an ability to manage the associated risks. Stock prices fluctuate widely, in marked contrast to the stability of bank deposits. This is something that could affect not only the individual investor or household, but also the economy on a large scale. Therefore, I think it's important to discuss the risks of the financial sector in general and the stock market in particular. This could be even more important now that so many newcomers have entered the stock market.

Allow me to quote the following:

"With each passing year, the noise level in the stock market rises. Television commentators, financial writers, analysts, and market strategists are all overtalking each other to get investors' attention. At the same time, individual investors, immersed in chat rooms and message boards, are exchanging questionable and often misleading tips. Yet, despite all this available information, investors find it increasingly difficult to profit. … Stock prices skyrocket with little reason, then plummet just as quickly, and people who have turned to investing for their children's education and their own retirement become frightened. There appears to be no rhyme or reason to the market, only folly."

This is a quote from the preface to a recently published biography about the well-known and long term value oriented investor Warren Buffet.[1] Buffet began his career forty-five years ago with only 100 U.S. dollars and has over the years built himself a multibillion-dollar fortune. I quote the passage to illustrate a view held by some of what was going on in the stock market during the end of the 20th century and the beginning of the 21st.

Learn from new theories

From experience we know that investors may temporarily pull financial prices away from their trend level. Over-reactions can occur so that excessive euphoria drives prices unduly high, just as undue pessimism can push them down too far. New theoretical and empirical arguments have been put forward against the notion that financial markets are efficient.

According to the efficient market hypothesis, it is only changes in fundamental factors, such as profits or dividends, that ought to affect share prices. Something that no doubt helped to question the explanatory power of the efficient-market hypothesis was the stock market crash in 1987, when the Dow Jones index plummeted 22.6 per cent - the largest-ever one-day fall in the United States. This dramatic event demonstrated that share prices can fall even though nothing more fundamental appears to have happened; a thorough search failed to detect any specific or unexpected development that might account for the crash. It also seems to be the case more generally that many price movements are not occasioned by new information; a study of the fifty largest one-day share price movements in the United States in the post-war period confirms this.[2] Moreover, a number of studies have shown that price movements have occurred solely because the company in question has been included in or excluded from Standard & Poor's 500 index, without any new information about fundamentals.

Various explanations for such overreactions have been found. For instance, research has shown that risk management systems and the use of strategies such as stop-loss limits and VaR limits, theoretically could cause financial markets to overreact.

Other research has shown that different forms of psychological factors can also cause those developments. Experimental psychology has found that people often perceive a wider pattern in the light of just a few observations that are actually entirely random. In the present context this means that a succession of good news items about a company's profits may lead investors to project the trend well into the future and accordingly generate an over-reaction; if the share price then rises, this is seen as confirming the analysis. A period of good returns also boosts the investor's self-confidence, making her/him bolder and more prone to take risks. Bit by bit the over-reaction takes shape and, if the worst comes to the worst, leads to a bubble.[3]

A phenomenon - also studied in experimental psychology - that works against taking an independent stance is group thinking. It is not easy to stick to an opinion that differs from what a majority of the group seems to hold; "surely all the others cannot be wrong" is a common thought. An example with which you may be familiar is the reluctance to enter a restaurant that is empty; people generally prefer one that has many guests - they simply rely on the judgement of others.

Even if you hold a different opinion from others, it could be profitable to act as you think the majority will. An investor who considers a stock to be valued above its fundamental level could still decide to buy or hold on to the stock if he or she believes that others might still be interested in buying the stock at an even higher price, for instance due to the factors mentioned earlier. In a paper the authors draw

1 Hagstrom, R.G. (2001): *The essential Buffet*, John Wiley & Sons, Inc. New York.

2 Cutler, D., J. Poterba and L. Summers (1991): Speculative dynamics, *Review of Economic Studies* 58, pp. 520-546.

3 See e.g. Tversky, A. and D. Kahneman (1974): Judgement under uncertainty: heuristics and biases, *Science* 185, pp. 1124-1131.

an analogy with a game of poker.[4] In normal times the market behaves like a game of roulette; the probabilities are known and independent of the investment decisions of the different players. In times of market stress, though, the game becomes poker. The players have to take into consideration the position of others and their likely behaviour.

We are also liable to succumb to wishful thinking. An example that confronts me almost daily at present is when supporters of a national football team, for instance, are frequently over-confident about the chances of winning.

Learn from history

The so-called IT boom, combined with markedly lower transaction costs as a result of new technology, induced many inexperienced people to invest in shares. Moreover, access to the Internet leads to an increased number of share transactions, often with poorer results. Investors have also become younger. The same tendency applies to stockbrokers and analysts, many of whom began their careers in the 1990s. Inexperienced investors did not get the assistance and support they needed. In the period running up to the Nasdaq crash, less than 1 per cent of the analyst's recommendations had been to sell. The media accentuated the exuberant mood, with reports of rapidly rising share prices, and the notion that quick money could be earned in the so-called new economy became the conventional wisdom.

From the recent years' experience I can identify some important and interesting issues. Although time does not allow me to expand on them, allow me nevertheless to mention some briefly.

What can be done to make the stock market function better? What can be done to provide more support in the future for long-term saving by households? How could more education and knowledge be provided so that the inexperienced investor becomes experienced and well-educated instead.

I'm sure that shareholders associations all over the world have an important role to play in this respect. Further, it goes without saying that prompt, up-to-date, correct and relevant information is crucial. However, we must remember that more information is not the same as better information. Quality is not the same as quantity. The inexperienced investor must be helped to interpret the information and pick out what matters most. An important role could be played by independent analysts, not to mention media. There have to be agents in society that can see through and criticise corporate managements that are unduly optimistic or provide information selectively.

The argument for this is that international studies indicate that in the second half of the 1990s firms, banks and analysts had incentives to talk inexperienced people into investing in new enterprises on grounds that were not entirely sound. Many new technology companies were not generating a profit and had to rely instead on paying for wages and equipment by issuing shares. For this to be feasible, stock market valuation needs to be high. In this sense there were incentives for managements to trim reports and statements about their firm's future profits. At the same time, analysts and investment banks, with potential earnings from launching share issues, lacked incentives to take a critical look at these reports, so inexperienced investors did not get the assistance and support they needed.

In order to reduce the risk of financial market imbalances, it is important that we have a well thought-out legislative, regulatory and supervisory infrastructure that functions properly and follows changes in the rest of the world. This is a never-ending task that requires the participation of all concerned.

Today, households face what are sometimes very difficult risk-management decisions that were not called for or even possible before. Many people still lack the relevant knowledge for this and it may be asked whether people in general can be expected to have such knowledge in the future. Everyone cannot be a specialist in risk management and financial theory.

Therefore, I think banks and other financial institutions should become more consumer-oriented, instead of today's greater focus on products. The increased exposure of households to the stock market calls for tailor-made plans for the life cycle that take all important risks into account. Central matters here are, of course, investment horizons, how buying and selling is arranged and the degree of diversification across companies and geographical regions. Another parameter is, as indicated, the

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[4] Morris, Stephen and Hyun Song Shin (1999): *Oxford Review of Economic Policy*, vol. 15, no 3.

life cycle; the possibility of saving for the long run is restricted by how much capital is likely to be needed in the nearer future.

Admittedly, this process has to some extent begun already. However, the decisive steps lie ahead.