The transformation of Wall Street

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Looking back at Wall Street in the 1960's, historians of finance will almost certainly conclude that the decade's most important event was the "institutional transformation"—no simpler term seems available—of the stock market. When the 1960's began, pension funds, mutual funds, insurance companies and other institutions together held about 15 per cent of American-owned common stock. When the decade ended, institutions' shareholdings were up to about 25 per cent of the total; Manuel F. Cohen, the former chairman of the Securities and Exchange Commission, estimated the value of their holdings early this year at over $260 billion. In 1960, institutions accounted for less than 25 per cent of New York Stock Exchange volume. The figure now is over 40 per cent; in addition, a significant and rising amount of institutional trading now takes place off the board.

The larger role of the institutions is by now a familiar proposition on Wall Street and has been noted in the press. Somewhat less attention has been paid to the broad exodus of individual investors from the stock market. The fact that they are getting out might be inferred from the corollary fact that the institutions have been going in.
But the business pages have for some reason never really focused on the persistent and heavy net selling of stock by individuals.

Before the 1950's, any such phenomenon would have been impossible because the institutions that bought stock were few and relatively small; every time an individual sold stock, there was almost certainly another individual on the "buy" side of the transaction. During the 1950's, the growth of pension funds created a large potential buyer for stock, and toward the end of that decade, these funds began to show a sizable appetite for stock. Still, until 1959 there had never been a year in which individuals were net sellers of stock.

Since that year, however, they have sold more stock than they bought in every year and in every kind of stock-market environment; and the rate at which they were selling seemed to be rising at the end of the decade. Indeed, one might sum up the market of the 1960's by noting that it consisted of individuals selling stock to institutions. In 1969, for example, individuals sold about $10 billion of stock on balance (the figure excludes mutual-fund shares). In the same year, private pension funds bought $5.4 billion worth of stock, public pension funds bought another $1.8 billion, mutual funds bought $2.5 billion, life insurance companies bought $1.6 billion, and other institutions bought several billion more.

The reasons why

There seem to be two principal reasons for this large and continuing transfer of stock from individuals to institutions. One reason, apparently, is that stock is worth more to institutions—first, because institutions are more likely than individuals to diversify; second, because it is easier for them to hold for the long term. It is clear that both differences critically affect the rates of return on stock investments. The massive study of stock prices in 1926-65, conducted jointly by the University of Chicago and Merrill Lynch, Pierce, Fenner & Smith, reached these conclusions, among others: 1) For investors who picked "small groups of stock at random, instead of just one, the risk of loss would have been considerably reduced and the probability of a larger profit considerably improved." 2) For investors not forced to sell during recessions, the "chance of making a profit and the amount of profit would have both been significantly increased." Thus it is reasonable to conclude that, in general, institutions enjoy higher rates of return than individuals do. And so it is also reasonable to assume that they have been bidding stock away from individuals.

Another reason for the institutionalization of the stock market may
lie in the transformed economics of the stock-brokerage business. Because the business is labor-intensive, the cost of processing individuals' trades soared during the inflationary latter 1960's. During this same period, volume rose sharply: from less than 5 million shares on an average day on the NYSE in 1964 to almost 13 million in late 1968. In an effort to handle the accompanying paper blizzard, many firms both staffed up heavily and expanded their investments in data-processing equipment. Both changes had the effect of raising break-even points considerably. In 1964 a typical medium-sized broker with predominantly individual customers was probably in the black on days when volume ran over 4 million shares. By the spring of 1970, the broker was probably in the red on days when volume was under 12 million.

And by that time volume was under 12 million on most days. By that time, furthermore, many brokers could not operate profitably even on high volume if it represented an accumulation of small trades. The "Aunt Jane" who had been wooed so persistently during Keith Funston's years as president of the Big Board was now a most unappealing business proposition. Early in 1970 there was probably not a brokerage firm in New York that could make money by executing an order to buy 50 shares of a $20 stock: quite a few firms were losing money even on 100 shares. Everyone, however, had been able all along to make money on the 10,000-share blocks generated in institutional trading; and everyone, accordingly, had long since set up an institutional department. When Aunt Jane walked in the door with $1,000, her broker tried to talk her out of that $20 stock and to sell her a mutual fund. The broker's commission on the fund was considerably higher (the firm would typically receive $70 on a $1,000 purchase, compared to only $15 for an odd-lot $1,000 stock purchase); besides, mutual-fund owners do not trade as much, and so the probability that Aunt Jane would be back soon with another profitless proposition was reduced. Even Merrill Lynch, the world's largest and most profitable brokerage house, which had resisted mutual funds, regarding them as a threat to the basic brokerage business, stopped resisting in 1969 and began offering funds to its customers.

In short, one considerable reason for the sizable move of individuals out of stocks and into mutual funds in recent years is that their brokers have steered them to the funds. In 1969, when individuals were net sellers of almost $10 billion of corporate stock, they were net buyers of $5.6 billion of mutual-fund shares.

As the outlines of the new institutional market for stocks first came into focus a decade ago, Wall Street greeted it with immense satis-
faction. To members of the New York and American stock exchanges, the institutions looked wonderfully profitable: revenues rose directly in proportion to the size of the big new orders generated by the institutions, while the costs associated with executing the orders were scarcely any higher than those on a 100-share lot. In addition, there was a widespread notion in the early 1960's that this large new institutional demand would act as a permanent support under stock prices. That is, there was clearly a large new participant on the demand side of the price equation; there was no reason to suppose that the supply of stock would be growing at a greater rate than it had; and so, the conventional wisdom of the Street had it, prices would be forced up. And that was not all: it was also part of the conventional wisdom that price changes would be less erratic as more of the stock came into institutional hands. Small investors might panic in declining markets and might be overenthusiastic in rising markets, in both cases exaggerating stock price movements. Institutions had better research and greater cash resources than individuals and would be able to prevent price gyrations from getting out of hand.

Every one of these assumptions is now in question. The brokerage community, though heavily dependent on institutional business for what profits there are today, is beginning to realize that the institutions pose a threat to the basic arrangements of the brokerage business and the exchanges.

To begin with, the profitability of institutional business has been undermined or threatened in several different ways. First, the Securities and Exchange Commission began in 1966 to press for a "volume discount" in commission rates, i.e., it wanted proportionally lower rates for big transactions—and was unwilling to accept the New York Stock Exchange's proposal that the change be accompanied by proportionally higher rates for small transactions. The SEC has not yet determined what rates it deems appropriate; but in December 1968, while it was still holding hearings on the issue, the NYSE unilaterally implemented a new rate schedule that included volume discounts and, Manuel Cohen has estimated, reduced commissions overall by some $150 million a year. In addition, the Antitrust Division of the Justice Department has raised the question whether there should be any minimum rates at all, for the first time raising the prospect of free competition in setting commissions. The Street today is gloomily persuaded that free competition would be murderous; its anxieties are focused especially on the institutions, whose bargaining power would be far greater than that of individuals.

The view that institutions represent a permanent support under
stock prices pretty much vanished in the 1969-70 bear market. In the long run, the view probably has a limited validity: if stock is indeed worth more to long-term holders, and if institutions on balance hold for longer terms than individuals, then it is doubtless true that institutionalization means somewhat higher prices. But quite a bit more than this was claimed in the early 1960's. It was then often argued that institutions—pension funds especially—represented a quite new source of demand; that they could be counted on to grow prodigiously; and that, investing for the long term in a permanently inflationary economy, they had nowhere to go but stocks for the bulk of their investments. Proponents of this view often sounded as though there was no price-elasticity at all in the demand for stocks. Beyond that, they often seemed to forget that the growth rates of institutional demand were approaching certain limits.

A diminished appetite for stocks

In the 1950's and 1960's, pension funds' appetites for stock were growing for four different reasons. First, more and more large companies began, after the 1949 steel settlement, to adopt pension plans for their employees. Second, they had to fund not only the benefits attributable to present and future, but also to past employment; in other words, the employer's contributions are especially steep in the fund's early years, while the employer catches up on past-service funding. Third, the notion that pension funds should own stock, which seemed rather adventuresome in the early 1950's, caught on steadily, so that the proportion of their assets fund managers wanted to be in stocks grew fairly steadily. In 1950 private pension funds had $6.7 billion of financial assets, of which 16 per cent was in corporate stock. In 1960 they had $38.2 billion of financial assets, of which 43 per cent was in stock. In 1970 they have slightly over $100 billion of financial assets and perhaps two thirds of that is in stock. Today most big corporations already have pension plans; their plans have largely funded the past service of their employees; and their stock ratios are probably about as high as they would like them to be.

Thus the demand for stocks attributable to pension-fund growth is approaching the point at which only the fourth source of growth is left—the slow, long-term growth associated with an expanding labor force. In the short term, furthermore, pension funds may now sometimes act to depress stock prices. As long as the funds were in general working to increase their stock ratios, it was unlikely that they would
ever get to be net sellers on balance; but now, with their ratios presumably close to their long-term objectives, their managers are freer to decide that bonds are a better buy than stocks, and to liquidate substantial amounts of pension-fund stock—something the market had never yet experienced but that looked quite plausible in the spring of 1970. (In a speech to the New York Society of Security Analysts last March, Henry Kaufman of Salomon Bros. & Hutzler, a major institutional brokerage firm, pointed out that bond yields, at 9 per cent for high-quality issues, had reached the “expected long-pull return on stocks, including dividends and price appreciation.” Kaufman added that, furthermore, “the high return on bonds currently is a contractual payment into the future while the 9 per cent growth on stocks is [only] an extrapolation of past trends.”)

The notion that institutionalization of the stock market means a smoother ride for stock prices is also seldom heard these days. It is true that institutions turn over their portfolios somewhat less than individuals, but the difference is less than it used to be; and it is abundantly clear that the mutual funds, whose turnover rates are higher than those of other institutions, have by themselves a capability for generating turbulence in the marketplace. Some mutual funds in the last year or two have turned over their portfolios at rates of around 100 per cent—i.e., rates equivalent to the creation of an entirely new portfolio every year. The rate for all mutual funds in 1969 was 45 per cent—more than twice the rate of the mid-1960’s. A fair number of corporations now regard substantial mutual-fund holdings of their shares with more alarm than satisfaction. The earlier notion that such holdings were “in strong hands” and not vulnerable to dumping in market panics has been replaced by a feeling that such holdings are the most vulnerable of all.

The four markets

Thus from the viewpoint of the Wall Street community, the institutionalization of the stock market no longer looks like the bonanza that was envisioned in the early 1960’s: it is not as profitable as anticipated, it will clearly not be the support under stock prices that some anticipated, and it will clearly not do much to prevent wild swings in prices. Indeed, the new view of many members of the exchange community is that the institutions look profoundly subversive these days, that they threaten many of the exchanges’ own institutions with obsolescence. Perhaps most directly threatened are those in the cockpit of the exchanges, the specialists. Traditionally,
they have been responsible for matching up buy and sell orders on the floor and for preserving orderly markets; and they have come to seem especially inadequate in an institutional era. But the problems for the exchanges extend beyond the specialists, and the very notion that the exchanges are the stock market has to some extent been eroded in recent years. There is a countervailing notion today to the effect that they are really just one of four different markets.

The second market, of course, is the over-the-counter market, in which the "continuous auction" of the New York, American, and other stock exchanges—an auction presided over by the specialists—is replaced by a process of negotiation. The over-the-counter market is nothing new, of course, and has traditionally provided the means of trading unlisted securities. What is new is the so-called "third market," in which securities listed on the NYSE are themselves traded over-the-counter, i.e., at prices negotiated by the buyer and seller. The purpose of this arrangement is to accommodate institutions, whose purchases or sales are often so large that they overwhelm the traditional exchange mechanism: they have to pay more or receive less than the market price in situations where their own orders constitute the bulk of the demand or supply for particular issues; in addition, the exchange's specialist, who is supposed to step in himself when no other buyer or seller can be found, often finds himself financially unable to handle institutions' orders. Third-market dealers, who had their own substantial inventories of listed securities available to prospective buyers, and who were able and willing themselves to buy substantial blocks, began springing up in the early 1960's to fill this gap in the exchange mechanism. While the third market accounts for perhaps 5 per cent of the volume in NYSE-listed stocks, it is responsible for 25 per cent of the volume in a few heavily traded institutional favorites.

Toward the end of the decade, some members of the exchange provided another alternative to the traditional system by offering "block positioning," an arrangement in which large and well-heeled firms offer to buy stock in amounts that specialists cannot handle and hold the stock in their own accounts until they can market it; such firms often lose money on the "spread" between prices they pay and the prices they can get for stock, but they may recover the loss, and more, in commission fees. In 1969 there were over 500 transactions involving more than 100,000 shares each; about a fifth of them were handled by the largest of the block-positioning houses, the NYSE member firm of Salomon Bros. & Hutzler. Since the block positioners operate within the confines of the Big Board, they are technically
part of the primary market; but it is clear that they, too, are chipping away at the traditional specialist system.

Potentially the most revolutionary development of all is the fourth market, which consists simply of transactions between institutions, without any brokerage firms or exchange mechanisms participating at all. In principle, of course, any shareholders can buy stock, from other shareholders, or sell it to them, or simply swap, and thereby avoid brokerage charges. Individuals find ways to do business directly with one another occasionally, and some institutions have done so—there is, for example, a long history of swapping between the Ford and Rockefeller Foundations. But for the fourth market to evolve into something more than occasional deals between institutions that happen to hear fortuitously about one another’s interests, rather special forms of communication are required. Some enterprising salesmen have made it their business to keep records of institutions’ portfolios and to look for swaps that seem logical. The most ambitious fourth-market operation is one called Institutional Networks Corp., which has been trying for over a year now to sell a large number of institutions on a sophisticated computer system that would allow those joining the system to trade with one another anonymously, rapidly, and commission-free (although fees would be paid to the network). \(^1\)

**Redefining the central market**

The exchanges, and especially the Big Board, have repeatedly assailed all such efforts as threats to the central market, contending that the new markets for listed securities could not function without the pricing mechanism provided by the exchanges but that this mechanism is increasingly impaired as more and more volume drifts away from the exchanges. The contention seems less plausible today than it did when it was first articulated a decade ago. The main difficulty with it is that so much volume has already drifted away, and so much other volume that is still reported in the NYSE totals is in fact bypassing the exchange’s pricing mechanism, that it is no longer clear that the exchange really is the primary market.

The Big Board is thus increasingly vulnerable to attempts to redefine the central market, e.g., as in an aggressive presentation made last fall to the SEC by Weeden & Co., a major third-market house. “We are not opposed to the Central Market Place Concept,” said Donald E. Weeden in his testimony. “We give it our wholehearted

\(^1\) For a detailed description of this operation, see “Challenge to the Brokers,” in *Fortune*, April 1969.
support. However, the NYSE version of the Central Market Place is truncated and self-serving. By building a wall around its own special privilege, the Exchange has kept out the capital, the inquiry, and the participation of other market makers, and restricted its own members from seeking better markets away. The result is that the NYSE is itself fracturing the Central Market Place.” Weeden went on to propose “an up-to-date version of the Central Market Place, involving computers and electronic display panels . . . enhanced by a ‘public’ ticker tape capable of reporting trades in all market places, including all exchanges, on a real time basis.”

The proposal may or may not be implemented, but it seems fair to say, in mid-1970, that there is nothing the least bit visionary about it. The new technologies have made it possible to redefine our securities markets. And the new institutions have made it probable that this will happen.