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IN WALL STREET WE TRUST

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Last year, Merrill Lynch was accused of defrauding its clients by giving them corrupt advice about which stocks to buy. Internal e-mails demonstrated that its research analysts had publicly recommended stocks that they'd privately derided. The company wound up having to make a payment of a hundred million dollars, as part of a settlement with the New York Attorney General's office. And how did Merrill's retail clients react to all this? They gave the company eighteen billion more dollars to manage. It was a tough year for Citigroup, too, what with the revelations about chicanery at its Salomon Smith Barney division, whose customers lost vast sums of money on tainted stock tips from the likes of Jack Grubman. So what did the customers do? They gave Citigroup another thirty-five billion dollars to manage.

If Circuit City sold televisions that blew up after three months, people would probably stop shopping there. Why is Wall Street different? For one thing, Wall Street is selling a service, not a product, and customers demonstrate much greater loyalty to services than to products, because services usually involve personal relationships. An investor who has his money with Merrill Lynch forms a bond with his broker, not the firm. Just as voters will say both that Congress should be turned out on its ear and that their own congressmen should be reelected, investors can simultaneously belittle Wall Street and maintain that their brokers are really good guys. In a way, the Street is benefitting, perversely, from the bursting of the stock-market bubble; shellshocked investors are inclined to entrust their money to professionals, even if those same professionals had as much responsibility as anyone else for the mess.

Then, there's what's known as "the status-quo bias." Most people are cautious about their money and are reluctant to make changes—even sensible ones. A survey of Vanguard investors, for instance, found that in 2001 only fourteen per cent of them made any change in their investment choices. And a study the same year by the economists Brigitte Madrian and Dennis Shea found that the rate of participation in a 401(k) plan was determined, in large part, by whether people were enrolled automatically or had to choose to sign up. Apparently, when it comes to money, inertia rules.

Such conservatism is understandable, but its consequences are grave. Yes, the recent \$1.4-billion settlement between Wall Street and state and federal regulators will make it harder for the world's Jack Grubmans to prosper (and to go on golf outings, as a Lehman Brothers analyst discovered

last week, when he was barred from an investment-banking trip to Scotland). But the troubling conflicts of interest remain in place. And only if firms feel that those conflicts are costing them customers and profits will that change.

The overriding conflict is that most major firms—including Merrill Lynch, Citigroup, Morgan Stanley, and UBS—run both investment banks and brokerages. Investment bankers help companies sell stocks and bonds. Brokers help investors buy stocks and bonds. Companies want to sell high, investors want to buy low. Companies want Wall Street to make them look good, investors want Wall Street to tell them which companies actually are good. When the same firm is advising both sides, someone is going to get a raw deal, even if everyone is acting honestly.

There's nothing new about this. The investment-bank/brokerage combination was pioneered, in the twenties, by a man named Charles Mitchell, a jaunty, gladhanding huckster who turned his business, the National City Company, into a powerful machine for selling securities. As John Brooks described him in his book "Once in Golconda," "He pressed his men to move the merchandise as relentlessly as if it were shoes or hair oil." Much of that merchandise was stocks and bonds—often for South American countries with shaky finances, like Peru and Brazil—that National City would underwrite, then recommend to its customers. National City made money at both ends: a hefty underwriting fee, and then hefty sales commissions (and a sizable markup). Mitchell called it "manufacturing" securities.

"Peruvian bonds" may have given way to "Internet stocks," but the business of underwriting and marketing hasn't much changed. Wall Street firms are still manufacturing. There's nothing wrong with selling stuff or with looking out for your own best interests; after all, the whole point of a free market is to make the pursuit of self-interest economically efficient. But the free market works best when both parties to a deal know the score, and not when investors think that brokers and analysts are objective sages, instead of just gussied-up salesmen.

After a year and a half of scandal, investors have run out of excuses. The Street continues to get away with giving biased advice because customers have not punished it for doing so, even though there are plenty of alternatives (index funds, discount brokerages, and so on). Managing investors' money is more important to Merrill Lynch than investment banking, and Citigroup relies more on its reputation with consumers than on its ability to underwrite stocks and bonds. Still, neither company will change—say, by cutting its investment bank loose—until it is given a bottom-line incentive to do so. The economist Albert O. Hirschman famously observed that consumers have two ways of registering their discontent: "voice" and "exit." Since the bubble burst, investors, loyal to a fault, have agitated for change mainly by airing their grievances. But voice is a currency that is not widely accepted on the Street. So perhaps the time has come for investors to shut up and take their money somewhere else. Exit, pursued by a bear.