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"Injecting Common Sense Into Financial Markets"

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An elementary moral hazard problem plagues investment funds--namely that those of us who put our money in one of them simply do not have the ability to fully monitor what the investors do on our behalf, and they *do* occasionally possess priorities beyond maximizing our return. The debate over the fiduciary rule--which is still ongoing, of course--rested upon that perception.

While those of us saving for retirement or college *can* monitor the returns that accrue to our investments, this alone is insufficient to discern whether our investors are serving in our best interests: For starters, we often don't have the right perspective to judge the results. One wealth manager lamented to me that while his overt goal--one he carefully articulates to his clients--is to minimize risk and avoid chasing returns, his clients expect him to beat the stock market in bull markets and to do at least as well as cash in a bear market--a nearly impossible task on its face and impossible to do so if risk mitigation is important.

But even the act of doing an analysis of our return can be problematic: The Nobel Laureate Richard Thaler has found that the more often people check the performance of their portfolios the more often they are likely to move some portion of their portfolio, and we know that such active investing almost invariably reduces returns.

Of course, we cannot simply check out and ignore our retirement funds, regardless of what kind of fund our wealth resides in, because we simply cannot be sure that the people running our investments are, in fact, doing things that are beneficial for them but not necessarily for us.

For instance, the Department of Labor recently issued guidance that prohibited investment firms from declaring that letting ESG principles (that is, investing in businesses that hew to certain environmental, social, and governance standards) help direct investment, as an increasing number of investment funds are wont to do, goes against their fiduciary duties. That is, they cannot pretend that allowing these non-financial priorities to guide their investment decisions is actually in the best interest of the people whose money they invest.

Fortunately, there is now an entity that is pushing back on the rhetoric behind the politicization of the investment process that is called the Main Street Investors Coalition. Its main purpose is to call attention not just to the cost that such investing can impose on savers but also that some of the financial regulations imposed on companies to ostensibly protect small investors have come with a cost as well. It echoes the rhetoric espoused by SEC commissioner Michael Piwowar, who has hearkened back to the day when ordinary investors had access to the sorts of investment opportunities that today only seem to be available to the wealthy--most notably new and rapidly growing companies.

One way this unfortunate reality manifests itself, the group notes, is in the fact that the proportion of stocks owned by "main street investors" and not ordinary retail investors has fallen from 90% to 30% since the 1950s. There are many reasons for the decline, but one major reason lies in the fact that Sarbanes-Oxley, a law passed in the aftermath of the steep stock market decline in the early 2000s, has made it much more costly for startups to go public in the U.S., and even more difficult for individual investors to participate in start ups. As a result, fewer startups occur these days than in the halcyon 1990s.

This law is a major reason that companies like Uber, which is valued in the tens of billions of dollars, continue to eschew any public offering. While there is no guarantee that Uber will continue to grow, the fact that no ordinary investor can get in on the ground floor--or even the middle floor--of such potentially enormously profitable entities reduces the long run returns we can achieve.

Financial regulatory reform is invariably done with an eye towards the last crisis, mainly because it is difficult for politicians to act with any foresight: no politician gets credit with voters for improving a system most are unaware is broken.

Fixing our current system while ensuring it can withstand a future financial crisis should be a priority for our government. Congress appears to be close to passing legislation that would fix some of the provisions of Dodd-Frank that do not appear to be cost-effective, most notably via raising the threshold for banks to be considered systemically important and thus subject to ancillary capital constraints. But there are other cost-ineffective regulations that merit reconsideration as well.

But it will help the cause of improving our financial regulatory regime to have an entity to remind people that our financial markets should be run with people like us in mind first and foremost.

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