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Wall Street: Parasite or Public Partner?

By Paul R. Martel, President

The financial events of the last two years had damaging effects here in the US and abroad. Trillions of dollars of wealth were lost, institutions disappeared overnight, our federal deficit ballooned, housing values collapsed and unemployment soared. These events left many of us scratching our heads and worse, frightened millions of people. Despite sweeping financial reform legislation, it's hard to see that anything tangible has really changed. In fact, much of the reform legislation hasn't even been written.

In our view, much of the blame for this scenario lies at the feet of the culture of Wall Street and its investment banking firms. No one can deny the critical role that Wall Street plays in our economy. One might say that investment banking is the gas station for our capitalist system. It is the source of capital formation. Wall Street plays a fundamental role in raising the capital our system needs to function and grow. With the money raised through securities offerings, manufacturing plants are built, people are hired, raw material is unearthed, goods are produced, and new technology is developed. It is Wall Street that provides the fuel which keeps our economy healthy and growing.

But over the last few decades, Wall Street functions more like a parasite, feeding on and corrupting the very processes and institutions it is supposed to nurture and support. Trading now accounts for the lion's share of Wall Street revenue. What we see is a voracious appetite for "product" and revenue in a sales culture that exists for its own sake with no regard for the risks and ramifications of what it is creating. Former Fed Chairman Alan Greenspan in congressional testimony could only shake his head in disbelief at the fact that the major investment banks very nearly committed financial suicide. In a recent New Yorker article, John Cassidy asks an apt question in his article "What Good is Wall Street?" pointing out that much of what investment bankers now do is socially worthless. Cassidy points out that, "For years, the most profitable industry in America has been one that doesn't design, build or sell a single tangible thing." I would argue that the problem is not so benign. Instead of a supportive role, Wall Street now plays an exploitive or manipulative one. What social good comes from the securitization of nearly every economic event imaginable? Does society gain at all from constant product creation, packaging, repackaging and sales of dizzyingly complex schemes such as credit default swaps, auction rate securities, reverse convertibles, range accrual notes and sub-prime mortgage tranches?

What is most frightening is that the parasite in fact nearly killed its host. One good example is our municipal bond financing system. Municipal bond financing is fundamental to our daily lives providing funding for schools, hospitals, highways, water systems and more. For decades, municipal bond insurance, from companies like MBIA and Ambac, was fundamental to this funding process. An insured bond provided security and liquidity to investors and assisted cities, towns and states in their funding for infrastructure and development. Two years ago, almost overnight, these companies failed and their bond insurance became worthless. Companies whose soundness was fundamental to our communities were found to have speculative arms that took immense risks that no one understood. These risks bankrupted them almost overnight making the bond insurance worthless, lowering values and creating fear in the markets. As a result, we taxpayers will all pay more in taxes as the federal government is forced to shore up municipal financing. In the larger picture, Wall Street's recklessness played a big role in nearly bringing the world economy to the brink of collapse. Can its leaders be blind to what their culture has wrought?

We can point to little in the Dodd/Frank legislation that addresses these issues. The culture remains largely intact and we are left to fend for ourselves in the face of it. In Cassidy's words, "For a long time, economists and policymakers have accepted the financial industry's appraisal of its own worth, ignoring the market failures and other pathologies that plague it." We conclude that the basic building blocks of corporate finance have changed little over the generations but that the industry itself is hardly recognizable. It behooves the public to take great care in what they buy and from whom they buy it. The presumption that complexity, innovation and rapid turnover are necessary for financial success is a tempting but dangerous one. At YHB, we will continue to act as partners and guides to our clients to help them avoid the pitfalls in today's still dangerous financial landscape. We will continue to create and manage portfolios of high quality securities with minimal transaction cost and turnover. We will not sell products, pursue fads, or "chase" yield with creative financing techniques. As advocates for our clients, we will remain an efficient conduit to the capital creating power of Wall Street and will seek to avoid its sometimes corruptive influence.

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