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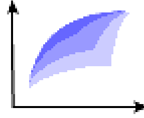

An Online Journal of Practical Asset Allocation

Edited by William J. Bernstein
and Susan F. Sharin

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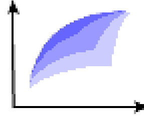

William J. Bernstein

Of Pigs, Troughs, Mutual Funds, and the Logic of Collective Action

If men were angels, no government
would be necessary.—James Madison

It's funny what readers pick up on. Write a book about the history of the modern West viewed through the lens of economics (*The Birth of Plenty*, McGraw-Hill 2004), and what do you get asked most often? Executive pay packages, a topic that occupied all of a sentence or two near the end of the book.

This is not a subject I'd thought deeply about; the book mentioned it only within the context of the wider data on increasing income inequalities. Still, it's an interesting question. Do executives at mediocre companies (or even good ones, for that matter) deserve eight- and nine-figure salaries and option deals? Of course not. How much do they damage the modern capitalist economy? Even more than you might imagine. Aside from the direct effects of the looting and dilution of bottom lines, there are few greater drivers of societal unhappiness than income inequality; the damage done to corporate morale by the chasm between those at the bottom and top of the ladder is beyond calculation.

Have the ethics of corporate executives deteriorated in the past few decades? Not at all. The primary benefit of exposure to the ancient Greeks and Romans is that they hit you over the head with the constancy of human nature—very little has changed in the past two-and-a-half millennia. Just as socialism's fundamental mistake was to assert the perfectibility of human motivation, so too are the William Bennetts of the world and other like-minded right-wing culture warriors seriously off base when they assert a recent deterioration of our moral fiber. (Keno, anyone?) Both sides of this divide would profit from a bit more Aristotle and Thucydides.

Likewise, you don't have to memorize the *Federalist Papers* to realize that the founding fathers, who were heavily influenced by the classics, had it exactly right: human nature is immutable, and men need governments. (Probably the most ardent proponent of government-as-character was John Adams, who was way too busy in Europe raising political support from the French, treaty concessions from the English, and money from the Dutch, to play editorial tag with Madison and Hamilton.) In the modern world, if moral fiber and ethics seem to have deteriorated, it's not that the human beast is decaying; it's just that not enough wrists are getting slapped.

No, I'm not suggesting that the federal and state governments inject themselves into the compensation-management business. The "government" I'm talking about is corporate-board oversight. And make no mistake about it, what we've witnessed in the past decade is nothing less than the complete collapse of the corporate-governance apparatus. The cookie-jar lid came completely loose, and mom and dad were nowhere in sight.

How did this come about? The answer lies in the work of an obscure thinker, the late Mancur Olson, best known among economists for a thin, insightful book, *The Logic of Collective*

Action. In it, Olson examines just how it is that the greater societal good so often gets hijacked by small special interest groups. Consider, for example, federal sugar subsidies. Each year, the United States pays about $1 billion in price supports to sugar growers. Most of this money goes to a tiny group of extremely wealthy families. The program is the most egregious part of a much larger system of agricultural supports that distorts world trade and encourages terrorism by devastating third-world growers and driving up unemployment in nations already on the brink.

And yet, year after year, a small elite of sugar growers is able to perpetuate, to the detriment of just about everyone else on the planet, this reverse Robin-Hood scheme. Olson's special insight lies in recognizing such a process and working out a mathematical model of it.

Translated into plain English, small groups are more cohesive, and thus more effective, than large groups. If you volunteer for the local beach cleanup, you'll get a warm glow, but if you don't participate, you'll benefit just as much from the pristine sand—what economists call the free-rider phenomenon. In a rural area, the cleanup organizers can use small-town suasion to get everyone to pitch in, but that doesn't work on Coney Island.

This logic of collective action applies in spades to sugar subsidies. It's relatively easy to organize a small number of billionaire plantation owners, each of whom reaps millions in benefits, into a cohesive and effective group; not so for those on the other side of the bargain—the 290 million Americans who indirectly pay a few dollars each to these clowns.

Olson's central intuition is that the larger the interest group, the harder it is to organize and the less effective it will be in achieving its goals.

Which is exactly what has happened to corporate ownership during the past few decades. Even fifty or a hundred years ago, governance was already diffuse enough that non-insider shareholders were no match for management. If you think that the recent shenanigans at Enron, WorldCom, and Adelphia represent something new under the sun, I suggest you reacquaint yourself with the Credit Mobilier scandal, which involved half of Congress and both of Ulysses Grant's vice presidents.

What *is* new in the late twentieth-century capital marketplace is its democratization. By the mid-1990s, about one quarter of households owned mutual funds, and most of them contained some shares of the worst of the large corporate miscreants of the past decade. Olson's logic of collective action dictates that diffusion of corporate ownership weakens the effectiveness of governance—it was just too hard to get the tens of millions of Enron or Time Warner-AOL shareholders to watch the beach, let alone clean it.

This may be changing. Large institutional shareholders, led by Calpers, have already begun to wield their share votes against greedy and incompetent managers. A more comprehensive solution, suggested by Vanguard founder Jack Bogle, would be a formal institutional-investor organization comprising the largest fund companies and pension funds.

Olson has much to teach the potential members of such an institutional consortium. The strength of any group, large or small, lies in the ability of its leadership to coerce members, through benefits, punishment, and social pressure, to cooperate and participate. A successful shareholder organization must find and push the hot buttons at Fidelity, Morgan Stanley, and Capital Research and Management; it will not be enough merely to set up an office on Connecticut Avenue.

Mr. Bogle might even want to have a friendly chat with some sugar growers.

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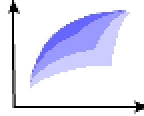

William J. Bernstein

Do Your Asset Classes Care Where They Are? Point/Counterpoint

Point

From time to time I get asked whether a dollar of a given asset class in a tax-sheltered account is equivalent, for the purposes of policy allocation, to a dollar in a taxable account. Let's take, for example, someone who owns a simple 50/50 portfolio of stocks and bonds in a portfolio equally divided between taxable and IRA accounts. The most intelligent way to allocate investments is to place the stocks in a tax-efficient vehicle on the taxable side and the bonds in the sheltered half.

Let's further assume that this individual's combined federal, state, and local tax bracket is 33.3%. Does this individual in fact own a 60/40 portfolio, since one third of the bonds will be taxed away upon distribution? (If he had $150,000 each in the taxable stock and sheltered bond accounts, and assuming that he has accrued no capital gains in the stock portion—a reasonable assumption after the recent market decline—then he has a total of $250,000 in after-tax assets: $150,000 in stocks and $100,000 in after-tax bonds.)

No.

Let's suppose that our retiree has just read *The Coming Generational Storm* and has concluded that marginal tax rates are due to increase dramatically and thus wants to draw down his sheltered account first. Further assume that he needs $20,000 in living expenses in the coming year. In this case, he distributes $30,000 from his sheltered account, pays $10,000 in taxes, and is left with the required $20,000. His portfolio now contains $270,000 in total assets. To stay at 50/50 he must exchange $15,000 in his taxable account into taxable or municipal bonds. Contrariwise, if he is not concerned with rising marginal rates, he can sell $20,000 of his stocks, in which case he now has $280,000 in total assets and must exchange $10,000 from bonds to stocks in his sheltered account.

Both of these transactions are mathematically equivalent in after-tax dollars. To drive home the point, were he to exchange *all* of his stocks for bonds in the taxable account and *all* of his bonds for stocks in the sheltered account, does he now own a *40/60* portfolio? Likewise, of course not.

Thus, to the extent that asset classes in sheltered and taxable accounts are fungible—that is, freely exchangeable—it makes no sense to discount sheltered dollars by the ordinary tax rate (and taxable dollars according to the proportion of capital gains due). Of course, one must still discount the *total* value of the portfolio according to the total amount of tax due, but it makes no sense to do this to individual asset classes according to their physical location.

However, this is *not* true if an asset class cannot be owned, *at the margin*, in a taxable account. The two best examples of this are junk bonds and REITs, which yield almost all of their long-term return in the form of dividends; if one is in a high tax bracket, one does not have the option of selling a REIT in a sheltered account and buying it back in a taxable one.

Theoretically, this might become a problem if you have only 5% of the portfolio in sheltered assets, have put every last cent of it into REITs, and decided to tap your sheltered account first. Only in this rather unusual situation would it make sense to discount the sheltered account.

The other problem arises because of the *future* composition of your accounts. While fungible asset classes held in taxable and sheltered accounts are equivalent in the *present*, this doesn't hold if the *future* returns of the two pools are greatly different. In particular, if your sheltered portfolio grows much faster than your taxable account, then a higher percentage of taxes will be due. Again, this is not a practical consideration; the most rational way to partition a portfolio with roughly equivalent taxable and sheltered accounts is to put most of the stocks on the taxable side, which will gradually reduce the relative tax burden of the portfolio.

Of course, all this is the accounting equivalent of rearranging deck chairs on the Titanic, paling into insignificance against the importance of future tax rates. Given the gargantuan unfunded liabilities of Social Security (about $5 trillion) and Medicare (at least $40 trillion), if you offered me a 45% marginal rate on my IRA withdrawals twenty years hence, I'd give it about as much thought as Donald Trump gives a job evaluation before I took the money and ran.

In most cases, your assets don't know or care where they are. By all means, discount your *total* portfolio by the total amount of taxes due. But, except in rare circumstances, you don't have to tie yourself into pretzels discounting each asset class according to its location.

Counterpoint

Needless to say, not everyone agrees with this formulation. Professor William Reichenstein, who holds the Thomas R. Powers Chair in Investment Management at Baylor University, cogently makes the opposite case in an article published in the *Journal of Wealth Management* in 2001. As a rebuttal, he has graciously allowed me to link to this piece, a well-written and oft-quoted article that makes the case that differential tax treatment mandates adjustment of the calculation of allocation. Readers are invited to consider both sides of this debate and draw their own conclusions.

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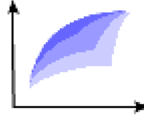

William J. Bernstein

The Boomers — Caviar or Cat Food?

Just how poorly prepared for retirement are the baby boomers? It all depends upon your definitions and assumptions. Sex, drugs, and rock 'n roll have given way to real return expectations, the treatment of home equity, and whether rising health-care costs count as an improvement in living standards. Read all about it in this exhaustive but well-written Congressional Budget Office report.

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