11/10/00 TALK OF CHARLES T. MUNGER TO BREAKFAST MEETING OF THE PHILANTHROPY ROUND TABLE

I am here today to talk about so-called “wealth effects” from rising prices for U.S. Common stocks.

I should concede, at the outset, that “wealth effects” are part of the academic discipline of economics and that I have never taken a single course in economics, nor tried to make a single dollar, ever, from foreseeing macroeconomic changes.

Nonetheless, I have concluded that most PhD economists under appraise the power of the common-stock-based “wealth effect”, under current extreme conditions.

Everyone now agrees on two things. First, spending proclivity is influenced in an upward direction when stock prices go up and in a downward direction when stock prices go down. And, second, the proclivity to spend is terribly important in macroeconomics. However, the professionals disagree about size and timing of “wealth effects”, and how they interact with other effects, including the obvious complication that increased spending tends to drive up stock prices while stock prices are concurrently driving up spending. Also, of course, rising stock prices increase corporate earnings, even when spending is static, for instance, by reducing pension cost accruals after which stock prices tend to rise more. Thus “wealth effects” involve mathematical puzzles that are not nearly so well worked out as physics theories and never can be.

The “wealth effect” from rising U.S. stock prices is particularly interesting right now for two reasons. First, there has never been an advance so extreme in the price of widespread stock holdings and, with stock prices going up so much faster than GNP, the related “wealth effect” must now be bigger than was common before. And second, what has happened in Japan over roughly the last ten years has shaken up academic economics, as it obviously should, creating strong worries about recession from “wealth effects” in reverse.

In Japan, with much financial corruption, there was an extreme rise in stock and real estate prices for a very long time, accompanied by extreme real economic growth, compared to the U.S. Then asset values crashed and the Japanese economy stalled out at a very suboptimal level. After this Japan, a modem economy that had learned all the would-be-corrective Keynesian and monetary tricks, pushed these tricks hard and long. Japan, for many years, not only ran an immense government deficit but also reduced interest rates to a place within hailing distance of zero, and kept them there. Nonetheless, the Japanese economy year after year, stays stalled, as Japanese proclivity to spend stubbornly resists all the tricks of the economists. And Japanese stock prices stay down. This Japanese experience is a disturbing example for everyone, and, if something like it happened here, would leave shrunken charitable foundations feeling clobbered by fate. Let us hope, as is probably the case, that the sad situation in Japan is caused in some large part by social psychological effects and corruption peculiar to Japan. In such case our country may be at least half as safe as is widely assumed.

Well, grant that spending proclivity, as influenced by stock prices, is now an important subject, and that the long Japanese recession is disturbing. How big are the economic influences of U.S.

stock prices? A median conclusion of the economics professionals, based mostly on data collected by the Federal Reserve System, would probably be that the "wealth effect" on spending from stock prices is not all that big. After all, even now, real household net worth, excluding pensions, is probably up by less than 100% over the last ten years and remains a pretty modest figure per household while market value of common stock is probably not yet one third of aggregate household net worth, excluding pensions. Moreover, such household wealth in common stocks is almost incredibly concentrated, and the super-rich don't consume in proportion to their wealth. Leaving out pensions, the top 1% of households probably hold about 50% of common stock value and the bottom 80% probably hold about 4%.

Based, on such data, plus unexciting past correlation between stock prices and spending, it is easy for a professional economist to conclude, say, that, even if the average household spends incrementally at a rate of 3% of asset values in stock, consumer spending would have risen less than ½% per year over the last ten years as a consequence of the huge, unprecedented, long lasting, consistent boom is stock prices.

I believe that such economic thinking widely misses underlying reality right now. To me, such thinking looks at the wrong numbers and asks the wrong questions. Let me, the ultimate amateur, boldly try to do a little better, or at least a little differently.

For one thing, I have been told, probably correctly, that Federal Reserve data collection, due to practical obstacles, doesn't properly take into account pension effects, including effects from 401(k) and similar plans. Assume some 63-year-old dentist has $1 million in GE stock in a private pension plan. The stock goes up in value to $2 million, and the dentist, feeling flush, trades in his very old Chevrolet and leases a new Cadillac at the give-away rate now common. To me this is an obvious large "wealth effect" in the dentist's spending. To many economists, using Federal Reserve data, I suspect the occasion looks like profligate dissaving by the dentist. To me the dentist, and many others like him, seem to be spending a lot more because of a very strong pension-related "wealth effect". Accordingly, I believe that present day "wealth effect" from pension plans is far from trivial and much larger than it was in the past.

For another thing, the traditional thinking of economists often does not take into account implications from the idea of "bezzle". Let me repeat: "bezzle", B-E-Z-Z-L-E.

The word "bezzle" is a contraction of the word "embezzle", and it was coined by Harvard Economics Professor John Kenneth Galbraith to stand for the increase in any period of undisclosed embezzlement. Galbraith coined the "bezzle" word because he saw that undisclosed embezzlement, per dollar, had a very powerful stimulating effect on spending. After all, the embezzler spends more because he has more income, and his employer spends as before because he doesn't know any of his assets are gone.

But Galbraith did not push his insight on. He was content to stop with being a stimulating gadfly. So I will now try to push Galbraith's "bezzle" concept on to the next logical level. As Keynes showed, in a naive economy relying on earned income, when the seamstress sells a coat to the shoemaker for $20, the shoemaker has $20 more to spend and the seamstress has $20 less to spend. There is lalapaloose effect on aggregate spending. But when the government prints

another $20 bill and uses it to buy pair of shoes, the shoemaker has another $20 and no one feels poorer. And when the shoemaker next buys a coat, - the process goes on and on, not to an infinite increase, but with what is now called the Keynesian multiplier effect, a sort of lalapaloosa effect on spending. Similarly, an undisclosed embezzlement has stronger stimulative effects per dollar on spending than a same-sized honest exchange of goods. Galbraith, being Scottish, liked the bleakness of life demonstrated by his insight. After all, the Scottish enthusiastically accepted the idea of pre-ordained, unfixable infant damnation. But the rest of us don't like Galbraith's insight. Nevertheless, we have to recognize that Galbraith was roughly right.

No doubt Galbraith saw the Keynesian-multiplier-type economic effects promised by increases in "bezzle". But he stopped there. After all, "bezzle" could not grow very big, because discovery of massive theft was nearly inevitable and sure to have reverse effects in due course. Thus, increase in private "bezzle" could not drive economies up and up, and on and on, at least for a considerable time, like government spending.

Deterred by the apparent smallness of economic effects from his insight, Galbraith did not ask the next logical question: Are there important functional equivalents of "bezzle" that are large and not promptly self-destructive? My answer to this question is yes. I will next describe only one. I will join Galbraith in coining new words, first, "febezzle", to stand for the functional equivalent of "bezzle" and, second, "febezzlement", to describe the process of creating "febezzle", and third "febezzlers" to describe persons engaged in "febezzlement". Then I will identify an important source of "febezzle" right in this room. You people, I think, have created a lot of "febezzle" through your foolish investment management practices in dealing with your large holdings of common stock.

If a foundation, or other investor, wastes 3% of assets per year in unnecessary, nonproductive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3%, "febezzelers" though they are, think they are virtuously earning income. The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself. And all the while what looks like spending from earned income of the receivers of the wasted 3% is, in substance, spending from a disguised "wealth effect" from rising stock prices.

This room contains many people pretty well stricken by expired years --- in my generation or the one following. We tend to believe in thrift and avoiding waste as good things, a process that has worked well for us. It is paradoxical and disturbing to us that economists have long praised foolish spending as a necessary ingredient of a successful economy. Let us call foolish expenditures "foolexures". And now you holders of old values are hearing one of you own add to the case for "foolexures" the case for "febezzlements" --- the functional equivalent of embezzlements. This may not seem like a nice way to start a new day. Please be assured that I don't like "febezzlements". It is just that I think "febezzlements" are widespread and have powerful economic effects. And I also think that one should recognize reality even when one doesn't like it, indeed especially when one doesn't like it. Also, I think one should cheerfully endure paradox that one can't remove by good thinking. Even in pure mathematics they can't remove all paradox, and the rest of us should also recognize we are going to have to endure a lot of paradox, like it or not.

Let me also take this occasion to state that my previous notion of 3% of assets per annum in waste in much institutional investment management related to stocks is quite likely too low in a great many cases. A friend, after my talk to foundation financial officers, sent me a summary of a study about mutual fund investors. The study concluded that the typical mutual fund investor gained at 7.25% per year in a 15-year period when the average stock fund gained at 12.8% per year (presumably after expenses). Thus the real performance lag for investors was over 5% of assets per year in addition to whatever percentage per year the mutual funds, after expenses, lagged behind stock market averages. If this mutual fund study is roughly right, it raises huge questions about foundation wisdom in changing investment managers all the time as mutual fund investors do. If the extra lag reported in the mutual fund study exists, it is probably caused in considerable measure by folly in constant removal of assets from lagging portfolio managers being forced to liquidate stockholdings, followed by placement of removed assets with new investment managers that have high-pressure, asset-gaining hoses in their mouths and clients whose investment results will not be improved by the super-rapid injection of new funds. I am always having trouble like that caused by this new mutual fund study. I describe something realistically that looks so awful that my description is disregarded as extreme satire instead of reality. Next, new reality tops the horror of my disbelieved description by some large amount. No wonder Munger notions of reality are not widely welcome. This may be my last talk to charitable foundations.

Now toss in with “febezzlement” in investment management about $750 billion in floating, ever-growing, ever-renewing wealth from employee stock options and you get lot more common-stock-related “wealth effect”, driving consumption, with some of the “wealth effect” from employee stock options being, in substance, “febezzle” effect, facilitated by the corrupt accounting practice now required by law.

Next consider that each 100-point advance in the S&P adds about $1 trillion in stock market value, and throw in some sort of Keynesian-type multiplier effect related to all “febezzlement”. The related macro-economic “wealth effects”, I believe, become much larger than is conventionally supposed.

And aggregate “wealth effect” from stock prices can get very large indeed. It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued partly like bonds, based on roughly rational projections of use value in producing future cash. But they are also valued partly like Rembrandt paintings, purchased mostly because their prices have gone up, so far. This situation, combined with big “wealth effects”, at first up and later down, can conceivably produce much mischief. Let us try to investigate this by a “thought experiment”. One of the big British pension funds once bought a lot of ancient art, planning to sell it ten years later, which it did, at a modest profit. Suppose all pension funds purchased ancient art, and only ancient art, with all their assets. Wouldn’t we eventually have a terrible mess on our hands, with great and undesirable macroeconomic consequences? And wouldn’t the mess be bad if only half of all pension funds were invested in ancient art? And if half of all stock value became a consequence of mania, isn’t the situation much like the case wherein half of pension assets are ancient art?

My foregoing acceptance of the possibility that stock value in aggregate can become irrationally high is contrary to the hard-form "efficient market" theory that many of you once learned as gospel from your mistaken professors of yore. Your mistaken professors were too much influenced by "rational man" models of human behavior from economics and too little by "foolish man" models from psychology and real-world experience. "Crowd folly", the tendency of humans, under some circumstances, to resemble lemmings, explains much foolish thinking of brilliant men and much foolish behavior --- like investment management practices of many foundations represented here today. It is sad that today each institutional investor apparently fears most of all that its investment practices will be different from practices of the rest of the crowd.

Well, this is enough uncredentialed musing for one breakfast meeting. If I am at all right, our present prosperity has had a stronger boost from common-stock-price-related "wealth effects", some of them disgusting, than has been the case in many former booms. If so, what was greater on the upside in the recent boom could also be greater on the downside at some time of future stock price decline. Incidentally, the economists may well conclude, eventually, that, when stock market advances and declines are regarded as long lasting, there is more downside force on optional consumption per dollar of stock market decline than there is upside force per dollar of stock market rise. I suspect that economists would believe this already if they were more willing to take assistance from the best ideas outside their own discipline, or even to look harder at Japan.

Remembering Japan, I also want to raise the possibility that there are, in the very long term, "virtue effects" in economics--- for instance that widespread corrupt accounting will eventually create bad long term consequences as a sort of obverse effect from the virtue-based boost double-entry book-keeping gave to the heyday of Venice. I suggest that when the financial scene starts reminding you of Sodom and Gomorrah, you should fear practical consequences even if you like to participate in what is going on.

Finally, I believe that implications for charitable foundations of my conclusions today, combined with conclusions in my former talk to foundation financial officers, go way beyond implications for investment techniques. If I am right, almost all U.S. foundations are unwise through failure to understand their own investment operations, related to the larger system. If so, this is not good. A rough rule in life is that an organization foolish in one way in dealing with a complex system is all too likely to be foolish in another. So the wisdom of foundation donations may need as much improvement as investment practices of foundations. And here we have two more old rules to guide us. One rule is ethical and the other is prudential.

The ethical rule is from Samuel Johnson who believed that maintenance of easily removable ignorance by a responsible office holder was treacherous malfeasance in meeting moral obligation. The prudential rule is that underlying the old Warner & Swasey advertisement for machine tools: "The man who needs a new machine tool, and hasn't bought it, is already paying for it". The Warner & Swasey rule also applies, I believe, to thinking tools. If you don't have the right thinking tools, you, and the people you seek to help, are already suffering from your easily removable ignorance.