23. Efficient Equity Markets Require Smarter Investors

CONTRARY TO THE FAMILIAR ADAGE, every cloud does *not* have a silver lining, although some do. The clouds cast by the recent freshet of corporate fraud and other derelictions have a brighter side that will improve the efficiency of equity markets in the future.

Among the acknowledged sources of brightened prospects are the recently enacted Sarbanes-Oxley legislation requiring CEOs and CFOs to certify the accuracy and completeness of quarterly corporate accounts and invoking serious criminal penalties including jail time for violations; improvements that have been made in the SEC's capabilities for rigorous yet sensible regulatory scrutiny of public companies; and the wake-up shock administered to corporate officers and independent directors to take their fiduciary responsibilities more seriously in the future than they may have in the past.

These developments, although important, are confined to the selling side of the market. More important, as well as less recognized as a stimulus to more efficient equity markets, is the

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buying side: specifically, the now-heightened incentives for investors to become more informed and knowledgeable about what they are buying when they invest. Efficient markets require participants—buyers no less than sellers—to have equivalent access to information, as well as the capacity to use it. When informational access is asymmetric—for example, sellers have it, buyers do not—prices will be distorted and resource misallocation will be the result.

The theory of efficient markets is one of the fundamentals of modern economics: one Nobel Prize has resulted from it, and several others have drawn from it. By strengthening incentives for investors to become more informed and knowledgeable, recent corporate malfeasances, paradoxically, should promote more efficient equity markets, improved resource allocations, and a more productive economy.

A recent comment by AFL-CIO president John Sweeney—not always a fan of efficient markets—is a cogent reminder of the direction of needed change:

> The sad truth is that American consumers can shop with more assurance of quality and safety at their corner grocery store than American investors can shop for equities in our stock market.

To be sure, bets with a longer-term horizon are inherently more risky than ones with a shorter term. But the principal reason consumers can shop with more assurance in markets for groceries as well as for appliances, vehicles, housing, and other durable consumer goods is that consumers are more knowledgeable about these products than they are about the products offered in equity markets.

Financial professionals scoff at this line of argument, contending in rebuttal that investment products are too technical and arcane for individual investors to understand as well as they understand consumer products and services. This rebuttal has limited merit, as well as more than a limited dose of self-interest associated with it.

Individual investors don't have to become financial professionals any more than consumers of health care (a major consumer service) have to become physicians. But it is entirely possible for investors to become sufficiently knowledgeable about investment products to ask the right questions and demand the information necessary to make better decisions in accord with their own preferences and judgments. The result will be more efficient equity markets.

Health care is no less arcane than investment, yet modern medical practice has been increasingly evolving in a corresponding direction. Intelligent consumers of health care need to know and understand such matters as high-density and low-density lipoproteins, triglycerides, hypertension, resting-exercise-and-recovery heart rates, and so on, to make more informed decisions. And physicians are now trained to convey to consumers (i.e., patients) de-jargonized information about technical matters, to encourage patients to seek second and third opinions, and to have patients share actively in medical decisions. Individual and institutional investors should require their financial advisers to do no less.

In the wake of recent corporate defalcations, and in view of the long-standing and pervasive informational asymmetries between buyers and sellers in equity markets, investors now have stronger incentives to become more expert and more current about the following types of technical issues that will affect investor behavior and, in the process, contribute to more efficient equity markets:

- The governance practices of companies in which individuals and institutions invest, or in which investment is contemplated: for example, the credentials of nonaffiliated directors, whether they are genuinely independent and free of conflicts of interest in their relationships with top management, and whether independent directors have dominant and preferably exclusive membership on the key audit, compensation, nominating, and governance committees of the board.

- The conceptual as well as empirical differences among corporate income, earnings, revenues, and profits: precisely how earnings have been measured in the past, whether recent and current measurement of earnings (of key importance for calculating price/earnings ratios) has been changed from previous benchmarks, whether earnings have been inflated or deflated (for example, by capitalizing rather than expensing such transactions as software replacement and equipment maintenance, recording revenues in advance for goods and services provided, or underfunding or overfunding pension obligations).
- The number of stock options issued or replaced, to whom issued and in what magnitudes, whether or not options are or may in the future be expensed (there are plausible arguments on both sides). Of equal or greater significance than whether options are expensed is the particular valuation method used for establishing option values (there are several reasonable methods with different effects on corporate earnings).

The efficiency of equity markets can be enhanced not only by rigorous enforcement of prior as well as new regulatory legislation but by effective standards setting and oversight responsibility to be exercised by the Public Company Accounting Oversight Board created by the new legislation and by improved regulatory scrutiny by the Securities and Exchange Commission.

All of these can help, but in the final analysis more-efficient equity markets depend fundamentally on better-informed and more discerning individual and institutional investors. Although the sell side of the market needs to be monitored, the buy side requires serious upgrading as well.

POSTAUDIT

In retrospect, the article is perhaps too uncritical of some downside consequences of Sarbanes-Oxley for the sell-side of securities markets. The focus on buy-side enhancements for efficient functioning of these markets, however, rings true five years after this was written.