Fischer Black
on
MARKETS

Vol. 1, No. 13
August 9, 1976

SPECULATION, NEW VENTURES, AND THE ECONOMY

Does the existence of options markets mean that there is less money around for investment in new ventures? Does it penalize the small businessman? Does it hurt society by making innovation more costly?

Similar questions can be asked about borrowing and short selling. When people choose to borrow less for investment purposes, or when they are forced to borrow less by changes in margin requirements, does that mean that less money is available for investment in areas of the economy that may have a critical need for capital? When people stay away from short selling because of uptick rules or the high cost of borrowing stock, does that allow more money to flow to firms that use high pressure selling to promote unsound enterprises?

Conservation Of Money

Issuing securities does not create money. If a firm issues securities, an investor gives up his money, but the firm gains the money, at least temporarily. When an investor writes options against his stocks, he takes in money from the option buyers, and must then decide where to invest or spend the money.

No money is created or extinguished by the sale or exchange of securities. Securities flow in one direction, and money flows in the other. Money is conserved.

Options trading has no direct effect on the money available for investment in small companies. When someone buys an option, he gives his money to the option writer. The same money is there: it's just in different hands. The option writer, who has a more conservative position than he had before he wrote his options, may decide to invest the money he receives in the same small company the option buyer might have invested in.

The creation of options does not absorb money. It is possible, though, that it puts money into the hands of people who are less inclined to invest in small companies. If certain people just love speculating, and are willing to take risks even when their rewards must be psychological rathar than monetary, it's possible that options may draw their attention away from speculative small companies. Option writers, who seem generally more conservative, may have less interest in these small companies.

It does not follow, though, that society is worse off as a result. Speculative attention to options will tend to cause an underlying stock and its options to reflect new information more quickly. To that extent, society will be better off, because spending decisions will be sounder and investments will more often be made in the right places.

Society may also be better off if speculative attention is taken away from small companies. Not all small companies deserve support. In fact, one might argue that most small companies should not be supported, since they never really become viable. The creation of options, if it does take support away from small companies, may take us closer to, not farther away from, the right amount of support for these companies.

The control of borrowing and lending works in similar ways. You can't restrict borrowing without also restricting lending. When you keep A from borrowing from B, you are at the same time keeping B from lending to A. So while A may have less money to put into risky investments, B has more money and he may choose to put it into the same risky investments. Money is conserved.

It turns out that restricting borrowing and lending does not affect the flow of money into investments generally, but does affect the types of investments chosen. With restricted borrowing and lending, high risk investments get more attention and low risk investments get less attention than either would get without the restrictions. Relative to the situation with no restrictions, high risk investments are overpriced, and low risk investments are underpriced. what about lenders who used to lend safely to traders? – they now buy low-risk securities.

If restricted borrowing causes too much emphasis on speculative investments, then restrictions on the growth of options trading may have the same effect. Restricted options trading may cause high risk investments to be overpriced, and low risk investments to be underpriced. And society may suffer.

Restrictions on short selling may also work this way. In principle, short selling can be a very effective way to keep speculative excesses under control. When a security is bid up too high by innocents, perhaps under the influence of high pressure sales people, short selling by informed investors can bring the price back down, or perhaps keep it from rising much in the first place. Thus <u>short selling protects the innocents</u>.

Restrictions on short selling do not affect the total amount of money available for investment, though. In a short sale, there is a buyer as well as a seller. The seller gets the buyer's money, and has the same kinds of alternate uses for the money that the buyer had. When a short sale is closed, there must be a seller as well as a buyer. So it's just as accurate to say that a large short interest in a stock represents potential selling pressure as to say that it represents potential buying pressure. Money is conserved.

Government control of options, of borrowing and lending, and of short selling has no special effect on overall investment, but tends to slow down the flow of information to securities markets and to cause new investments to flow into more risky new ventures rather than less risky new ventures.

The Individual vs. Society

Individuals seem to take pleasure from participating in new ventures. The pleasure they feel seems much like the pleasure that individuals take from trading stocks, even when they have no real expectation of making money. This feeling seems especially strong when an individual owns his own business. He may be willing to work for much less if he can be his own boss than he could earn working for someone else. It's also true, of course, that many people overestimate what they will make from an investment in a new venture.

To some extent, individuals making investments in new ventures, especially when they are trying to escape working for someone else, make society worse off by not taking the jobs in which they can make the greatest contribution. But frequently these individuals come up with new ways of doing things that are quickly spread throughout the economy. Sometimes the individuals get almost no benefit from their discoveries, or not enough benefit to cover their costs, because ideas are so easily copied.

In the end, at least if we ignore the pleasure that individuals take from the process, new ventures hurt most investors and help the rest of society. To take a simple example, many new restaurants serve high quality, low cost meals with great enthusiasm in the weeks or months before they run out of money. The people who eat there gain, and the people who invest their money and time there lose.

To the extent that government policy can influence the amount of investment in ventures like these, what approach should it take? Should it encourage new ventures, so that more money will be lost by the investors or by the government through subsidies? Should it discourage new ventures, so that society will benefit less from new ideas?

There's no clear answer. Perhaps this is another case where the government should step back and let competition determine which new ventures are started, and which new ventures survive. If allowing a new options market to grow diverts investors' attention from costly new ventures, perhaps it's just as well.

To be sure, this is the kind of situation where we can't be confident that competition will give the ideal result. When people take pleasure from an activity and often overestimate its monetary rewards, and when society benefits from an activity without having to pay its share of the cost, then competition may give too much of the activity, or it may give too little. In this situation, it's hard to tell which, since the indirect benefits and costs of new ventures are virtually impossible to measure. So it's hard to argue that any particular form of government intervention is worth the rather large costs of interfering with the workings of the free market.

Currently, the government regulates both individual and institutional investment in new ventures. The "protection" that is offered to an individual is aimed at reducing the chance that he will overestimate the likely payoff from a venture. To some extent, it is aimed at telling him that putting a lot of money in a new venture is not a good way to get a diversified portfolio. It's not clear that these messages get across very well.

Government regulation of institutional investment in new ventures is aimed at protecting individuals who own shares in the institutions. It is severe. Mutual funds and pension funds, for example, find it very difficult to invest in new ventures. The trouble is that by discouraging institutional investment in new ventures, the government is necessarily encouraging individual investment.

Thus the two kinds of regulation tend to cancel one another in their effects on individual investment in new ventures, except that I suspect that the net effect is to encourage individual investment. And all this regulation has large costs, both direct (to the government and the regulated firms) and indirect (because it creates incentives for inefficient behavior).

Discouraging institutional investment in new ventures is costly in part because institutions tend to be in a much better position to evaluate proposals calmly. What chance does an individual have when he meets a high pressure salesman? His only hope, normally, is simply to refuse to invest as an individual in new ventures. It's very unlikely that he would be in a position to do the kind of analysis an institution can do.

It may be that the best thing we can do to reduce the chance that an individual will make unwise investments in new ventures is simply to reduce the barriers to institutional investment in new ventures. There are venture capital firms, there are SBIC's, and many large corporations are constantly looking for profitable new ventures. So perhaps it doesn't hurt much to keep mutual funds and pension funds out of this business. But if we must favor either large investors or small investors in the new venture market, I vote for favoring large investors.

If individuals want to play, it seems to me that they will be better off playing with options or buying on margin or selling short than playing with new ventures. Investors in those more liquid markets will help make them reflect all the available information, and the fact that those markets already reflect almost all available information will protect the investor.

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