

CHAPTER 1**The Buttonwood
Tree**

The stock market is a source of endless fascination for investors and traders, both professional and amateur alike. Go to any bookstore and you will find an entire section with rows of books dedicated to giving advice on how to make money in the stock market. Often a quick killing or the opportunity to “get rich quick” is what is promised. People from all walks of life are drawn to the romantic allure of instant wealth that seems readily available from “playing the market.” Yet apart from this often more superficial interest, the stock market truly is an important factor in the lives of large numbers of people today in the developed economies of the world, and particularly so in the United States.

The American public is actually much more involved in the market than many are aware, going beyond the more obvious direct investments in stocks by individuals or by mutual fund managers who invest on private individuals’ behalf. It is true, however, that professional or institutional investors do dominate stock market trading these days rather than private individuals acting on their own. When you examine who these institutional investors are, whether money managers running mutual funds or other investment companies, pension funds, endowment funds, insurance companies, banks, and, increasingly hedge funds, it may seem that they are a world apart from the private individual. Principally these institutional investors are managing the retirement monies, insurance premiums, and savings of private individuals. In a very real sense, they control the financial futures of many millions of Americans. But there is also another way in which the general public is tied in with the stock market. A large proportion of working people in this country are employed at publicly quoted



companies, and so the fortunes of those companies and the private individuals who are their employees are also, to a large extent, tied to the ups and downs of the stock market.

What exactly is the stock market? Simply put, it is a market on which equity share ownership in publicly traded companies is bought and sold. The actual venue in which buyers and sellers meet, or more accurately where one is matched with the other, is the stock exchange. It was the joint-stock companies, such as the Dutch East India Company established in 1602, that were the forerunners of today's publicly traded corporations. The Dutch East India Company established a stock exchange to facilitate trading in its own stocks and bonds. That exchange became the Amsterdam Stock Exchange, generally considered the world's oldest. In recent years, the Amsterdam Stock Exchange merged with several European stock exchanges or *bourses* to form a larger, international market called *Euronext*. Euronext is made up of the exchanges of Amsterdam (AEX), Brussels (BSE), Paris (Bourse de Paris), and Portugal BVL (Bolsa de Valores de Lisboa e Porto) and includes also LIFFE (London International Financial Futures and Options Exchange). Euronext itself has recently merged with the NYSE Group, which includes the New York Stock Exchange.

This brings us to the buttonwood tree. It was on May 17, 1792, under a large sycamore tree—or a buttonwood as it was known in the vernacular of the time—in front of 68 Wall Street in New York, that 24 brokers signed the *Buttonwood Agreement*. This contract stated that the brokers would only trade securities with each other, would abide by a fixed commission rate, and would not participate in auctions. This stock exchange was not the United States' first—the Philadelphia Stock Exchange dates from 1790. However, it was this New York exchange that drafted its constitution as the New York Stock & Exchange Board on March 8, 1817, was renamed as the New York Stock Exchange in 1863, and became the country's and indeed the world's most important and influential stock exchange. Other stock exchanges, both within the United States, such as NASDAQ and a number of regional exchanges, as well as many important international exchanges have grown up over the years and are venues on which stocks can also be bought and sold by the institutional investor, professional trader, or private individual. Professional investors and nonprofessionals alike can choose to use their access to the stock market to allow them to build a portfolio of equity investments to grow their capital, to trade stocks with the aim of making short-term profits—or a mixture of both styles.

After the New York Stock Exchange, traditionally the next most important exchange for many years was the American Stock Exchange (AMEX). It had its origins in the mid-19th century when traders would meet outside the main exchange on the curb on Broad Street near Exchange Place, and

thus it became known as “the Curb.” Here stocks were traded that were not listed on the NYSE because they were relatively new companies that had not yet established a reputation that would merit a listing on the “Big Board,” as the New York Stock Exchange is often called. In 1921, the Curb traders moved indoors into a permanent domicile at 86 Trinity Place. Its name was changed in 1953 to the American Stock Exchange. Today most of the trading done on AMEX is of small-cap companies (those that have market capitalization between roughly \$350 million and \$1 billion), exchange traded funds (ETFs)—similar to index funds but traded like stocks, and derivatives, which are financial instruments that “derive” their value from some underlying asset.

In 1998, the AMEX was merged with the NASDAQ, which had already eclipsed the AMEX as the principal alternative exchange to the Big Board for younger and less-established companies. NASDAQ, the acronym for the National Association of Securities Dealers Automated Quotation, opened in 1971 as the first electronic stock market in the world, and it initially traded 2,500 over-the-counter securities. Today NASDAQ lists over 3,000 companies, specializing primarily in the technology sector including some very large companies such as Microsoft, Dell, and Intel. Unlike the New York Stock Exchange and the American Stock Exchange, NASDAQ never had an actual physical location where securities were traded because it was always a computerized exchange. Nevertheless in 1999, when the new Four Times Square building was erected in the heart of New York City—on Broadway between 42nd and 43rd Streets—a cylindrical tower located at the northwest corner of the building, the NASDAQ MarketSite, gave the exchange a visible “presence.” The NASDAQ MarketSite contains a seven-story screen that is illuminated constantly and is one of the most clearly identifiable sites in Times Square.

At the opening of this chapter, we mentioned that more people are involved with the stock market than probably know. Indeed, over the years there has been an increase in the number of Americans who are owners of stocks whether on an active or a passive basis. Early on in the market’s existence, investing and trading were very much the preserve of wealthy, private individuals. Bankers and brokers looked after the investments of the wealthy. If a regular person sought to put his meager savings to work in the stock market, he had to go to the *bucket shops*. Bucket shops were frequently scam operations based on very dubious business practices. Although their customers thought that the bucket shops were placing their orders on the Exchange itself, it was often the case that the bucket shops matched buy and sell orders themselves, with a big spread between the two ensuring a big profit for the bucket shop. In some senses a forerunner of modern-day market makers, but completely unregulated, the bucket shops’ business ethics were probably more akin to those of today’s

so-called boiler-room operations in that they often set out to fleece unsuspecting investors.

Access to the stock market became easier for greater numbers after World War I when many more Americans enjoyed real prosperity for the first time. Concurrently there was a rise in home ownership and a proliferation of household goods, particularly radio sets and telephones. By the late 1920s, millions of people also owned cars as the Ford Model T was mass produced and thereby became more affordable. With the rise of affluence of the average American, stockbrokers, just like other merchants, realized that there was good money to be made in this line of business and they started to advertise their services to the public in much the same manner as companies that were marketing the new consumer goods. More and more people were lured by the prospect of acquiring wealth in this way. Accurate statistics pertaining to the number of stock owners from this period are hard to come by, but one historian believes that between 2 and 14 million Americans in the 1920s were invested in the stock market, including those who had passive ownership in instruments such as corporate stock plans and pension funds.¹ Moreover, there was also a growing number of women who owned shares, and just to give a few examples—50 percent of the shareholders of Pennsylvania Railroad were women (and thus it was mockingly called the “Petticoat Line”) and 55 percent of AT&T shareholders were women.²

It is not surprising that with the crash of 1929 followed by the Great Depression, the American public tended to avoid Wall Street like the plague. It was only after the Second World War, and particularly during the 1950s, that Americans generally began to show a reviving interest in stocks. Just as with the end of World War I, consumer spending was on the increase, and more and more people were purchasing homes. Suburbs grew and flourished. Most American homes were now equipped with electricity and plumbing and were filled with all kinds of labor-saving devices and gadgets such as dishwashers, toasters, and vacuum cleaners. The middle class, now growing by leaps and bounds, became interested in investing as households now had more disposable income than previous generations, and was attracted by the prospect of making even more. Investing advice became ubiquitous. It could be heard on the radio and read in magazines and newspapers. It was at this time that mutual funds started to gain in popularity.

THE RISE OF THE MUTUAL FUND

A mutual fund pools money from a large number of individual investors and buys a diversified group of stocks, bonds, or other assets. Mutual funds

proved advantageous for the small investor who could achieve diversification with a relatively small amount of money. The mutual fund had its origins in the Netherlands in the 1820s, and in subsequent decades it spread to other parts of northern Europe. It made its way to the United States in the early 20th century with the first mutual fund created by Massachusetts Investors Trust in 1924. After the U.S. economy recovered from the crash of 1929 and the Depression, Congress passed the Investment Company Act in 1940 in order to protect investors. The act regulated companies that invested and traded in securities, including mutual funds, by calling on them to disclose information about their operations, finances, and structure. In the decades that followed the mutual fund became more and more a popular investment vehicle.

Aside from setting up safeguards in the form of legislation, the U.S. government made it more tax efficient for Americans to invest in the stock market. In 1981, the Internal Revenue Service (IRS) approved of a system whereby employees could save for retirement through a tax deferred instrument called the *401(k) plan*. This retirement plan was the brainchild of Ted Benna, who worked for a retirement consulting firm. A year earlier, Benna had discovered a small passage in the Revenue Act of 1978 that would allow employees to make contributions from each paycheck before the income is taxed. Taxes would be paid on these monies only when the employee started to withdraw them during retirement. Also, employers could match amounts invested. Over 25 years later, the 401(k) plan has become an important part of retirement planning for many Americans. In 2003, about 50 million people had 401(k) plans totaling \$1.8 trillion.³ Many 401(k) plans offer diverse investment options, including mutual funds, bonds, and money market accounts.

In this way the stock market indeed touched the lives of many Americans. Presently, about 55 percent or \$4.94 trillion of all mutual fund assets are in stock funds.⁴ Moreover, most 401(k) plans are invested in stock funds. A study conducted jointly by the Employee Benefit Research Institute and the Investment Company Institute shows that at the end of 2005, two-thirds of all 401(k) plans were invested in stocks. This statistic has not changed much over a decade, however. During the period between 1995 and 2005, the percentage of 401(k) accounts invested in stocks fluctuated only between 62 percent and 77 percent.⁵

Investment by the general public in stock mutual funds can be perceived as one factor in the “democratization” of the stock market and thereby the U.S. economy in general. Jay O. Light, a professor at the Harvard Business School, noted this contribution, commenting that mutual funds had made the capital markets easily available to ordinary citizens.⁶ However, the level of true democratization has its limits. It is true that in the years leading up to the Stock Market Crash of 1929, the portion of the

general public that owned stocks in any shape or form was a wealthy elite. The various developments just detailed led to increasing numbers of private individuals becoming involved in common stock ownership, especially in the post-World War II years and in particular the 1980s onward. This generated a very different picture, with about half of all U.S. households today owning stocks either held directly or indirectly through mutual funds, which form a major part of most people's 401(k) plans. However, given the indirect nature in which the majority of stock holdings are held—using mutual funds—it is still true to say that most private individuals are effectively passive investors and the stock market continues to be dominated by an elite—the elite being today those professional or institutional investors who manage huge amounts of money pooled in funds.

WHY FOCUS ON STOCKS?

They say that history repeats itself. The same can also be said of the economic, business, and financial worlds, which by nature follow cyclical patterns. Over the last decades there have been numerous times when the best investment to be in would be stocks, or bonds, or real estate, or gold—actually this does not happen often for gold, but it does happen as in 2005—or even artwork. While hindsight is always 20/20, it is difficult for anyone to foresee with certainty what area of investment will have its day next. Of course, there are some who consistently do predict these turns correctly. However, once again these are a handful of people with special talents that set them apart from the majority. For example, even those few of us who from time to time give thought to what is happening in the gold market, realized that gold would finally make a come-back in 2005 only after it had actually transpired.

The common stock—equity investment providing partial ownership in corporations—is the one asset class that has consistently outperformed all others over time despite having its own strongly cyclical nature. The post-World War II real rate of return on common stocks investment, net of inflation and including dividends, is approximately 7.1 percent and over any extended period this has bested all other forms of investment.⁷ This statistic, however, hides a lot of gut-wrenching ups and downs in the market as well as times when the market has for seemingly interminable periods gone nowhere. In the last 40 or so years, we have seen the listless and lethargic sideways movement of the market in the 1970s, a return to upward movement in the 1980s, the rip-roaring bull market in the unprecedented boom of the 1990s, and the latter's grindingly painful unraveling in the years 2000 to 2003.

While we do not disagree that over time the trend line for stock prices generally is upward, we demonstrate in the next chapter that the way many investment writers present their statistics on the historical “return on stocks” can be deceptive. Nevertheless, it is our feeling and experience that the “wind in your back” provided by the consistent increase in stock values over time, make common stocks the perfect vehicle for the short-term trading strategy that we espouse and that has worked so well for us. The ease and relative low expense of trading these instruments, particularly as far as the large-capitalization stocks are concerned, provide additional underpinnings to the advantages inherent in this approach.

CERTAIN ASSUMPTIONS

We are going to assume that the reader already has a basic understanding of how the stock market works, how a stock transaction is carried out accessing an exchange through one of the online brokerage services, and the basics of corporate America and the market economy or capitalist system in which we live. This book is not designed to go back to the very basics of describing what a stock is, how one goes about trading it, the difference between a stock’s bid and ask prices, and how information on stock prices are displayed by the financial press and on brokerage company screens. We also take for granted that the investor has a basic knowledge of such terms as *price/earnings (P/E) ratio* and *dividend yield*—although we provide contextual clarification on such things when and where necessary in the text.

Interestingly, many of the investing books that are written by the gurus and pundits of whom we have spoken before assume zero knowledge on the part of the reader, even explaining something as simple as the payment of a dividend in inordinate detail. We even came across one book in which the author wrote out a short dialogue illustrating the way in which an investor should place a call to his broker in order to purchase a stock. This demonstration bordered on the absurd when the author spelled out the exact words with which the reader should greet the receptionist on the phone and ask to speak to a broker! Surely books that seek to help people make decisions that involve stock purchases of many thousands of dollars are the wrong place to provide such hand-holding. Such people with no grasp on the subject matter might be better served if they were discouraged from risking their money in this way.

