REMARKS OF RICHARD B. SMITH, COMMISSIONER
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Institutional Investing

This morning's panel topic is institutional investing; my remarks are really introductory. It may be helpful to step back from the immediate turmoil of today and look at the process over a longer period of time. Since I am first on the program, I thought I would try to do this as a setting for our discussion, and so that the other panelists from whom you want to hear can spare themselves some of the history. But like all history, it is relevant to figuring out what to do tomorrow.

I point out the customary, that my remarks are an expression of my own views and do not necessarily and are not intended to reflect the views of my colleagues on the Commission or the staff.

Today we look back at 1929 as the great watershed in this century for our securities markets -- and it was, in that it led to our present market and regulatory structures. But in terms of institutionalization of securities ownership it was only a waystation. I suspect we shall be able to look back on 1970 in somewhat the same way, as a waystation, in terms of institutional investing.

What has been happening over the last seventy years? At the turn of the century institutions are estimated to have held about 7 percent of total corporate stock outstanding. Today, after various growth phases and plateaus it is around 25 to 28 percent.

Now the first thing to notice about these figures is the relatively slow pace of the development, a change of around 20 percentage points over seventy years. It is not as though all of a sudden financial institutions own more than a quarter of industrial America and that next year it will be more than half. There is no reason to become hysterical. But the other thing to notice is the deepness, the persistence of the movement. Why?

What we are observing over the long time span, I believe, are two or three large shifts in our economy. More and more of the nation's non-government tangible wealth has become held in corporate form. That reflects the industrialization of the country since 1900. At the same time more and more of our private sector intangible wealth has been shifting from personal and family holdings to institutions. It is only since 1900 that we have had income taxation, collective bargaining and social security. The great personal fortunes from the 19th and early 20th centuries have in many cases gone into independently administered foundations. By today pension savings, insurance pools, and collective investment vehicles for the moderately wealthy, have become the principal accumulations of investment capital.

The fact is that as our country has grown in size, industrial corporations and financial institutions have grown in size, and number. So has the number of individual direct investors; they continue to hold some 70 percent of corporate stock outstanding. The securities markets must serve all of them -- corporate issuers, institutional investors and individuals. Individual direct investors, of course, gained access to the securities markets through brokerage firms, which are themselves a form of financial institution. We have seen over the years a number of brokerage firms also grow into large enterprises.

And in recent years we have seen each of the major types of financial institutions -- banks, insurance companies, investment advisory organizations, brokerage houses -- both diversify their operations and intensify their attention to management of equity portfolios.

As to diversification -- otherwise called integration of financial services -- some might wish for simpler days. Where insurance company portfolios were mortgages and bonds, and variable annuities, separate accounts and variable life insurance were not invented, and broker-dealer affiliates were unthinkable. Where banks had no idea what commingled managing agency accounts were and brokerage allocation was not a systematic consideration and the trust business was predominantly personal estates and transfer agencies rather than competitively administered employee benefit plans. Where an investment adviser had individual clients, or a fund client, but not a complex of clients or insurance and

brokerage and offshore affiliates. Where securities firms perhaps performed one but not all of the functions of brokering, market-making, underwriting, venture capital and investment advising -- the latter, if looked at broadly, ranging from solicited customers to discretionary accounts to fund management.

Well, such a simpler world will not be, perhaps cannot and should not be. By referring to these aspects of diversification (or integration) in such a cacophonous way I do not mean here to ascribe anything good or bad to them. I want only to highlight some of the richly varied activities almost everyone in this business engages in. There are more I could mention. Many of these organizations each trade in or belong to a number of different securities markets in each of which the same security can be traded. And one firm is often both the customer and the competitor of the other. All these trends that tend to blur historic distinctions in financial groupings are running strong. More and more financial firms which once were limited purpose institutions are transforming themselves into explicit investment management organizations which also operate other related businesses.

I said earlier that in recent years in addition to diversifying, institutions have intensified their portfolio management. I meant several things by that. For one, as institutions grew and shifted into equities, they have tended to concentrate their portfolios into large positions in a relatively limited number of large market value issuers, almost always the leading listed companies on the New York Stock Exchange. For another, they have tended to adjust their portfolios more actively. This has reflected itself in common stock turnover rates two and three times as high as existed in the early 1960s and before. Because institutional turnover rates are substantially higher than for the market as a whole, and because institutional positions and consequently size of trades are substantially larger than for the market as a whole, institutional trading has come to account for some 60 percent of New York Stock Exchange dollar volume. New York accounts for about 80 percent of trading in its own listings, the balance occurring in the third market and on regionals. There the bulk (in dollar volume) of trades in New York listed stocks is also institutional in character.

Thus, while the growth in institutional <u>ownership</u> of equity securities appears to have occurred relatively slowly and persistently over a long period of time, the growth in institutional

trading is a phenomenon that appeared only in the past decade. How persistent it will be in its intensity remains to be seen. Whether all the trading was of benefit to the institutional beneficiaries is not free from doubt. But it does appear that some degree of the more active style of portfolio management of equities will remain with us for some time to come. Investment managers compete for funds and comparison of their performance -- hopefully on a risk-adjusted basis -- will be possible.

These institutional developments have had their impact on the securities markets -- in terms of pricing and liquidity, in terms of the conduct of the market-making function, in terms of the structure of the markets, and in terms of brokerage commissions. I have talked to some of these impacts before, so I, like you, would now prefer to hear from the other panelists on the subject. It might be pertinent as you listen to them to be asking yourselves questions that underlie the title given to this panel discussion: What is an institution? What is investing?

Thank you.