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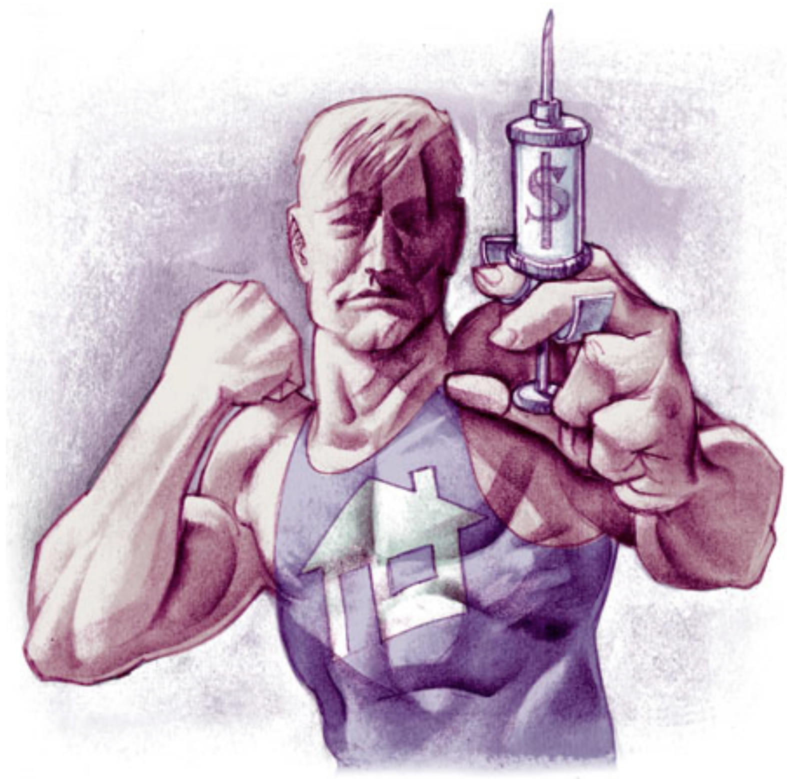
Pursuit of an Edge, in Steroids or Stocks

By ROBERT H. FRANK



ASSET bubbles like the one that caused the current economic crisis have long plagued financial markets. But like hurricanes in the Gulf of Mexico, these disasters have been occurring with increasing frequency. If we want to prevent them, we must first understand their cause.

It isn't simply "Wall Street greed," which Senator John McCain has blamed for the crisis. Coming from Mr. McCain, a longtime champion of financial industry deregulation, it was a puzzling attribution, squarely at odds with the cherished belief of free-market enthusiasts everywhere that unbridled pursuit of self-interest promotes the common good. As Adam Smith wrote in "The Wealth of Nations," "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."

Greed underlies every market outcome, good or bad. When important conditions are met, greed not only poses no threat to Smith's "invisible hand" of competition, but is an essential part of it.

The forces that produced the current crisis actually reflect a powerful dynamic that afflicts all kinds of competitive endeavors. This may be seen clearly in the world of sports.

Consider a sprinter's decision about whether to take anabolic steroids. The sprinter's reward depends not on how fast he runs in absolute terms, but on how his times compare with those of others. Imagine a new drug that enhances performance by three-tenths of a second in the 100-meter dash. Almost impossible to detect, it also entails a small risk of serious health problems. The sums at stake ensure that many competitors will take the drug, making it all but impossible for a drug-free competitor to win. The net effect is increased health risks for all athletes, with no real gain for society.

This particular type of market failure occurs when two conditions are met. First, people confront a gamble that offers a highly probable small gain with only a very small chance of a significant loss. Second, the rewards received by market participants depend strongly on relative performance.

These conditions have caused the invisible hand to break down in multiple domains. In unregulated housing markets, for example, there are invariably too many dwellings built on flood plains and in earthquake zones. Similarly, in unregulated labor markets, workers typically face greater health and safety risks.

It is no different in unregulated financial markets, where easy credit terms almost always produce an asset bubble. The problem occurs because, just as in sports, an investment fund's success depends less on its absolute rate of return than on how that rate compares with those of rivals.

If one fund posts higher earnings than others, money immediately flows into it. And because managers' pay depends primarily on how much money a fund oversees, managers want to post relatively high returns at every moment.

One way to bolster a fund's return is to invest in slightly riskier assets. (Such investments generally pay higher returns because risk-averse investors would otherwise be unwilling to hold them.) Before the current crisis, once some fund managers started offering higher-paying mortgage-backed securities, others felt growing pressure to follow suit, lest their customers desert them.

Warren E. Buffett warned about a similar phenomenon during the tech bubble. Mr. Buffett said he wouldn't invest in tech stocks because he didn't understand the business model. Investors knew him to be savvy, but the relatively poor performance of his Berkshire Hathaway fund during the tech stock run-up persuaded many to move their money elsewhere. Mr. Buffett had the personal and financial resources to weather that storm. But most money managers did not, and the tech bubble kept growing.

A similar dynamic precipitated the current problems. The new mortgage-backed securities were catnip for investors, much as steroids are for athletes. Many money managers knew that these securities were risky. As long as housing prices kept rising, however, they also knew that portfolios with high concentrations of the riskier assets would post higher returns, enabling them to attract additional investors. More important, they assumed that if things went wrong, there would be safety in numbers.

PHIL GRAMM, the former senator from Texas, and other proponents of financial industry deregulation insisted that market forces would provide ample protection against excessive risk. Lenders obviously don't want to make loans that won't be repaid, and borrowers have clear incentives to shop for favorable terms. And because everyone agrees that financial markets are highly competitive, Mr. Gramm's invocation of the familiar invisible-hand theory persuaded many other lawmakers.

The invisible hand breaks down, however, when rewards depend heavily on relative performance. A high proportion of investors are simply unable to stand idly by while others who appear no more talented than them earn conspicuously higher returns. This fact of human nature makes the invisible hand an unreliable shield against excessive financial risk.

Where do we go from here?

Many people advocate greater transparency in the market for poorly understood derivative securities. More stringent disclosure rules would be good but would not prevent future crises, any more than disclosing the relevant health risks would prevent athletes from taking steroids.

The only effective remedy is to change people's incentives. In sports, that means drug rules backed by strict enforcement. In financial markets, asset bubbles cause real trouble when investors can borrow freely to expand their holdings. To prevent such bubbles, we must limit the amounts that people can invest with borrowed money.

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