

The darkness behind the problems

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We look at the night sky, and see roughly a hundred thousand stars on a clear night. But there's a lot more to the universe than we can see with the naked eye, as a remarkable new video makes clear. It tells the story of how the astronomers who work with the Hubble telescope decided to point their eye in the sky at a dark empty spot out in space--and the surprising result.

<http://www.flixxy.com/hubble-ultra-deep-field-3d.htm>



Meanwhile, here at home, you read about our economic difficulties--the federal debt, various scams and ponzi schemes, entire nations going bankrupt--and it's sometimes hard to see past the bright headlines to the darker, better-hidden underlying causes of all these problems. But a recent report issued by economist Woody Brock of Strategic Economic Decisions, Inc. gives us a Hubble-like view of the deeper structural problems with our global society.

Brock says that most of our troubles are blamed on incompetence, but in fact the people who have allowed the immense debt crises in Greece, Ireland and Iceland were actually quite competent and acted quite rationally before, during and after the crisis. The same is true about members of Congress who routinely ignore the fact that the country has promised to pay out more in Medicare, Medicaid and Social Security payments than the current tax structure can possibly collect. The Wall Street executives whose actions brought about the near-collapse of the global economic system were not exactly dummies, and their behavior, too, was quite understandable and rational.

Instead of saying that our global and economic leaders were incompetent or delusional, Brock offers a much simpler and clearer explanation: he says that, over time, the incentives that these people operated under gradually drifted farther and farther from the optimal. By acting perfectly rationally, they brought us ever-deeper into scandal and catastrophe.

For instance? Politicians get elected by promising that the government will give voters more than they will have to pay for. They get thrown out of office if they say that we're going to have to get serious and not only pay for what we get, but also pay back what we borrowed over the last 30 years--either in the form of higher taxes, cuts in Social Security or Medicare, a reduced military or some other difficult decision. The result: until there is an actual, immediate crisis, there is every incentive to keep kicking the budget deficits down the road, and even more incentives to promise tax cuts without any corresponding cuts in the services delivered by the government.

The same, of course, is true in Greece, Ireland, Iceland, Spain, Portugal and every other country that got so deeply in hock.

Entrenched special interests and lobbying groups, meanwhile, are well-paid to deliver their views to Congress, and their contributions help our elected representatives afford all the expenses of travel and advertising that are required to stay in office. These lobbyists, of course, expect to get back much more than they spent in the form of tax breaks, loopholes and reduced regulation on things like pollution and safety--otherwise there is no rational reason to spend the time, effort and money. But there is no comparable lobbying organization on behalf of ordinary citizens. The result? The special interests get more than their fair share--impoverishing everyone else precisely to the degree that their lobbying efforts are successful.

If you were a politician up for re-election, would you turn down their money, knowing your opponent would take it in a heartbeat? If you were a special interest group that routinely received more than you were spending on lobbyists--in the form of tax breaks, subsidies or less stringent regulations--would you voluntarily decide to close down your PAC?

The incentives on Wall Street may be even more skewed in the wrong direction. Wall Street executives and traders receive huge bonuses on the money they bring into the firm, and they get to keep it even if those corporate revenues were generated by a lot of risky bets which might blow up in spectacular fashion two, three or five years down the road. By the time that we discover those were losing bets, the traders and executives will have pocketed millions in bonuses. When the global economy freezes solid from so much gunk in the wheels, they can always retire comfortably. Who wouldn't take such risks, given this kind of reward structure?

Of course, in real life, the firms simply retrench, take new risks and pay out record bonuses two years after the crisis. This article by the Christian Science Monitor takes an amusing look at what you might do if you were lucky enough to receive the average bonus given out by Goldman Sachs in January 2010:

<http://www.csmonitor.com/Business/2010/0121/Top-10-ways-to-spend-a-Goldman-Sachs-bonus>

In fact, for Wall Street, it gets worse. By far the largest profit center at the large brokerage firms and investment banks is what they call "proprietary trading." In simplest terms, proprietary trading can be defined as a brokerage firm investing its own money in the market, trying to find profitable investments and strategies. The activities became famous when it came to light that Goldman Sachs, a leading investment banking firm, had made billions betting against the subprime mortgage-backed securities market that it was creating and selling to its customers--and this illustrates the problem.

If the firm sees a profitable investment, is it going to immediately run out and tell its customers, or invest its own money?

If the firm thinks an investment it owns is likely to lose money in the future, or go spectacularly bust, will it eat the loss, or make that toxic investment available to its customers? As the incentives are now, the firm would have good reason to tell brokers to recommend the investment it wants to unload--especially if, like the subprime mortgages, it was also making money manufacturing investments that made no economic sense. The logic seems to be: If you're sucker enough to buy it, why shouldn't they sell it to you?

The recent Dodd-Frank financial regulation bill requires regulators to look hard at whether to ban this activity--a watered-down version of the so-called Volker Proposal that would have ended it altogether. According to an article by Michael Lewis for Bloomberg News, brokerage and investment banking firms are already making deals with outside hedge funds to "request" certain trades, so that the same activity will go on in the name of various cozy customers. Meanwhile, there was nothing in the bill that would prevent insurance agents from selling toxic products called equity indexed annuities. Why would they do that? The commissions they receive every time they talk a customer into buying can be up to five times higher than they would get for selling variable annuities.

All of this helps to illustrate why the massive lobbying arms of the brokerage and insurance industries are fighting against a standard of care that would require all who give advice to put the interests of the customer/client first-like doctors do. They argue that it would limit consumer "choice." But if you point the telescope deeper into their argument, it's all about protecting their skewed set of incentives: "If we have to live under this fiduciary standard, and treat all of our customers like we would treat our own mother, how could we possibly generate tens of billions of dollars in profits?"

Of course, the politicians who are raking in campaign contributions from these firms have zero incentive to probe deeply behind their arguments. And so the circle turns all over again.

Dr. Brock's point is brilliantly simple: incentives matter. All of us-politicians, brokers, senior executives, global leaders, ordinary citizens-tend to act in our own best interests. If the best interests of key decision makers and linchpins of the global economic system are badly-and increasingly-misaligned with what is good for all of rest of us as a whole, then we all have a very, very large problem. This helps us see more clearly a deep, dark underlying reason why crises continue to erupt and visible problems continue to be ignored.

Until we find a way to fix the incentives, we are unlikely to find lasting solutions.



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