ADVISOR PERSPECTIVES

Robert Shiller on the Social Benefits of Finance

By Laurence B. Siegel
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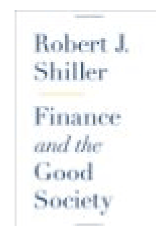
It's a bad sign for the finance industry that one of its leading minds – the distinguished Yale economist Robert Shiller – has felt compelled to write a book in order to defend the idea that finance itself is a constructive pursuit, worthwhile to modern society. Have things really gotten that bad?

One of my favorite explanations of finance describes it as the set of innovations that make it possible to pay for a $100 million airliner today with the proceeds of tickets that will be sold for $100 a piece over the next 40 years. But Shiller, whose new book is *Finance and the Good Society,* takes a surprisingly – and refreshingly – different tack, describing finance as the stewardship of society's assets.



That portrayal, in my mind at least, applies more to the specialty of investment management than it does to finance generally. But at a time when the very concept of finance, not just its practice by imperfect people, is being vilified as a destructive force, Shiller's defense of it is most welcome.

While I laud his efforts, however, Shiller's rallying cry for finance could have been more full-throated. Shiller asks big questions. What is finance? What is it for? How does it help people? How does it hurt them? How has finance worked its way into the structures of everyday life? These topics give readers a chance to mine so rich a lode of moral philosophy and economic history that, when I saw the author and title, I expected a mind-altering book on the order of Milton Friedman's *Capitalism and Freedom*, or Henry Hazlitt's *Economics in One Lesson*.

What Shiller delivers does not achieve those heights - but it is still a fascinating read.

Finance and society: Not preaching to the business-school choir

It is clear from the first words of his introduction that Shiller anticipates a hostile audience. Lamenting that, in common parlance, the word "finance" is synonymous with "ensuring that the rich grow richer," and that the field is widely seen as antithetical to an egalitarian "good society," Shiller acknowledges that his readers' first impressions of finance may be that it is at odds with their values.

This is not the approach of a man who expects to be preaching to the choir. Shiller is addressing the wider world – outside the walls of the Yale School of Management – where people assume that poverty exists not because there are too few rich people, but because there are too many. Such confused logic prevails in the press and even more so in most of academia.

Another prevailing sentiment that Shiller tries to confront is the belief that those who get rich in finance receive more than their due, at least when compared with those in more favored, more tangible enterprises like manufacturing, technology, and construction. Implicit in this criticism is a notion that finance is a kind of infrastructure or public utility; it mostly matters when it is broken.

Shiller is sympathetic to the idea of finance as infrastructure, but he does not think that means it should necessarily be inexpensive. The availability of well-administered and creatively designed financial services makes a huge difference to the prosperity of a society, he argues, so it is natural that finance jobs are well compensated, especially because they also require a high level of education and technical expertise. But Shiller defends high compensation for CEOs more vigorously than for financiers; he has some sympathy for the idea that finance salaries are bloated, correlate too closely with the stock market, and seduce too many talented young people away from other productive activities in the economy. "Financial capitalism does not *necessarily* produce unjust wealth distribution," he concludes (the emphasis is his). "Public policy can allow us to enjoy the benefits of modern finance without producing such inequality."

Since Shiller does not contemplate salary caps, presumably he means that taxes can be more progressive or more specifically targeted to profits from financial activities. To square finance with the good society, Shiller would allow quite a bit of room for policies that many readers would consider confiscatory.

The financial zoo

The best part of *Finance and the Good Society* is a set of brief essays – no more than eight pages each – that detail the function of various important creatures in the financial zoo: investment managers, investment bankers, ordinary bankers, mortgage originators, traders, etc. These vignettes illuminate well why it is that the financial sector is so complex and why it employs such a large population of highly-skilled and well-paid workers. Beyond revealing what each category of finance professionals does for a living, how they do it, and what ethical pitfalls they may encounter, Shiller also explains their social function – how each contributes to the greater good of society.

To Shiller's credit, he covers, with respect and seriousness, some species that finance scholars often rank as inferior or unimportant: accountants, regulators, lawyers, and even lobbyists. (Shiller's explanation of the positive role of lobbyists offers valuable insight into James Madison's ideal of a political system responsive to competing private interests.) One gets the feeling that this section was intended to be the heart of the book, and that the less cohesive remainder, called "Part Two: Finance and Its Discontents," is a set of essays that the author has been collecting, waiting to find a home for them.

Part Two does cobble together a range of fascinating ideas, though, touching on more or less everything Shiller has previously written about: bubbles and market inefficiency, good and bad uses of debt, behavioral finance, the importance of trust and the existence of sleaze, the tendency of universities and charitable institutions to accumulate assets instead of spending them, the democratization of capital ownership, and the prevention of war. Thinking broadly about great issues is what Shiller does best, and Part Two offers a window into his formidable and creative intellect.

The stewardship of society's assets

The way Shiller divides the industry, the stewardship of assets is provided by two groups: investment managers, discussed in Shiller's second chapter, and the consultants or (in the case of personal investing) financial advisors who select or recommend the managers, discussed in Chapter 10.

Shiller's main concern is whether active managers add value or whether, instead, they are intellectual frauds claiming to be able to add value relative to a market benchmark when, more often than not, they don't. Shiller concludes that active managers are not frauds and that, at any rate, having a large group of smart people thinking about the correct valuation of securities cannot really be a bad thing.

Shiller misses a chance, however, to dig deeper and clearly state *how* active managers potentially benefit the investor. The returns of all active managers must sum to the market return, minus fees and other costs. But some managers will beat the market, not necessarily randomly. To the contrary, the smarter managers, or those with better access to information, will, on average, earn higher returns than the others (and also higher than the market benchmark). Thus, 1960s-era efficient market theory notwithstanding, it is *not* useless to try to earn alpha. "Not everybody wins" is different from "nobody wins!" The returns earned by the best managers are much higher than luck or random variation would dictate.[1]

Financial products that transfer risk in novel ways

Shiller is perhaps best known for his creative thinking about using financial innovation to achieve social goals. In previous works, especially his book *The New Financial Order* (2003), Shiller has proposed, for example, derivatives based on a country's GDP and on the wage level in a trade or profession. Using such instruments, he argues, one can hedge "macro" risks, making personal risk-taking more tolerable and creating a safety net if things do not work out. Shiller sprinkles *Finance and the Good Society* with references to these ideas. Because these are Shiller's most visible recent contributions to finance

[1] See, for example, Kroner, Kenneth F., Scott W. Clifford, and Laurence B. Siegel, "The Greatest Return Stories Ever Told," *Journal of Investing*, Summer 2001.

and have sparked a good deal of discussion (and even spawned some actual securities), I'll go into some detail on them here, even though *Finance and the Good Society* does not.

GDP derivatives

Shiller's proposed GDP derivative, called a trill (as in "one-trillionth"), is a claim on one-trillionth of a particular country's GDP each year. It would presumably be structured as a GDP-linked bond. Based on current nominal GDP data,[2] a Japanese trill would pay a coupon of $5.87 this year, and the coupon would grow or shrink at the same rate that Japan's nominal GDP does. A Vietnamese trill would pay a coupon of 12 cents this year, also growing or shrinking to mirror changes in GDP. An investor could thus bet on Vietnam growing faster than Japan by buying Vietnam trills and financing them with a short position in Japan trills. The government of each country, according to Shiller, would be motivated to issue trills rather than nominal debt because it would then owe less money in the event its GDP declines.

But there are some problems with this hypothetical security. If it were widely believed that Japan is going to decline while Vietnam is likely to boom, the market for this pair of trills would not clear, except at prices very different from par. Vietnamese trills would immediately sell at a premium in the secondary market, because their anticipated growth rate would be greater than the discount rate (the rate used by investors to reduce future expected values to a present value or bond price). Likewise, Japanese trills would sell at a discount. The government of Vietnam would most likely then refuse to sell trills at par, because it could get a higher price in the secondary market. The government of Japan, meanwhile, would not be able to sell trills in the *primary* market, because no one would want to pay the face price.

When the prices have adjusted and the market did clear, most or all of the advantage from the long-Vietnam, short-Japan position would have already disappeared. That means such a bet would really be a bet that the differential growth rate of the two countries is higher than the market-determined "spread," or consensus difference in growth rates, a very different matter from betting that one country will outperform the other. Likewise, the advantage to the government that issues trills would be mostly or completely eliminated. It's possible Shiller worked out these difficulties in other, more technical writing, but if he has done so, there is no mention of it in *Finance and the Good Society*.[3]

[2] Not adjusted for purchasing power parity.

[3] The problem I have identified is also not addressed in Kamstra, Mark, and Robert J. Shiller, "The Case for Trills: Giving the People and their Pension Funds a Stake in the Wealth of the Nation," Cowles Foundation Discussion Paper 1717, August 2009, http://cowles.econ.yale.edu/P/cd/d17a/d1717.pdf. This article does, however, recognize that trills will be traded in the secondary market and includes a simulated back history of market prices for these securities.

Livelihood insurance

Another Shiller innovation with promising risk-transfer attributes is livelihood insurance, structured as a contract with payoffs linked to the average wage in an industry. A student contemplating a career as a teacher could thus hypothetically hedge declines in teachers' standard of living in the event of, say, government budget cuts. The problem here is that this insurance would be very expensive and most people would only be able to afford it when they are older and richer, after the event insured against has already occurred.

Other financial innovations

Shiller has also proposed that government pension payoffs, for example from Social Security, be restructured so that they pay in GDP-linked units. This would tie Social Security promises to the taxpayers' collective ability to pay and head off the kind of entitlement crisis that the U.S. expects to face within a generation.

Shiller's proposal for house price insurance would have mitigated the recent housing crisis, because the insurance would have reimbursed homeowners who have underwater mortgages, enabling them to stay in their houses and keep up mortgage payments; one wonders, however, whether the insurers would have been bankrupted, given just how much housing prices declined.

Finally, in chapter 22, Shiller offers this provocative suggestion:

> Mortgage borrowers should have, in the initial debt contract, a preplanned workout. The continuous-workout mortgage that I have proposed would specify changes in the terms of the mortgage in the event of an economic contraction or a fall in home prices.

Such a contract would eliminate much of the human misery that foreclosures represent and would greatly reduce transaction costs. A continuous-workout mortgage, however, has its own costs. Inability to pay the originally contracted amount is correlated across borrowers, so lenders might all take a hit at once, precipitating a new financial crisis. And homeowners who never missed an originally contracted payment, despite periods of unemployment, illness, or other hardship, might wonder why they bothered (and paid a higher price than their neighbor did for the same house).

The theme unifying these innovations and my critiques of them is that thinking about ways to make markets more complete is worthwhile – but some markets are incomplete for a reason. It is not practical to have fully functioning markets, without overwhelming moral hazard or other inefficiencies, in everything; and it is not possible to eliminate all risk through financial innovation.

Financing the good society

I think of a good society not as one that is strictly egalitarian, but as one that is organized for the comfort and convenience of ordinary people. Of course, finance is compatible with a good society thus defined. It's how ordinary people pay for things they need and want, but which they do not have the immediate resources to buy. This principle also applies to government finance (roads and bridges are needed now, while tax revenues dribble in over decades) and corporate finance.

The stewardship of society's assets – individual savings, pensions, endowments, and foundations – is another invaluable function of finance; people and institutions deserve to earn as high a risk-adjusted return on their savings as they can.

Of course, finance, especially in its more complicated forms, opens doors to abuses, which must be policed.

All of these are basic ideas that should be taught in high school. Shiller deserves praise for an eloquent exposition of these principles, or at least the beginnings of one – a full treatment could fill an encyclopedia. More troublingly, we, the people, should be embarrassed that we need to have them explained to us at all.

To those outside the field, such spirited support for finance as Shiller's may surprise. But to those readers steeped in the culture of finance and made aware of its social value, through their education or experience, it's his defensive tone that may seem jarring. I urge any such readers to look past that discomfort. We should not expect Shiller to live in, and write for, a bubble of business-school professors, students, and finance practitioners, as too many of us often do. He is writing for the world, and it is reasonable for him to tee up his arguments by citing, with some sympathy, the critiques of finance that have been circulating in the popular press and the academy over the last few years.

The poetry of commerce

Perhaps the best measure of an author is the poetry he quotes. Shiller cites Walt Whitman:

> A Song for Occupations!
> In the labor of engines and trades and the labor of fields I find the developments
> And find the eternal meanings.[4]

Shiller admires Whitman, not just as a poet, but as an artistic entrepreneur and self-promoter. Whitman is one of a number of artists whose lives blurred the line between the spiritual and ideal, on the one hand, and the practical and financial on the other. This line, Shiller argues, is too often drawn as though goodness resides only on one side, the

[4] "A Song for Occupations," in *Leaves of Grass* [1892. First edition 1855].

artistic. Reflecting on the above passage, Shiller writes that "it is in the facilitation of the full variety of human activities – of an active human society with a richness and diversity shared and appreciated by all people – that finance manifests its most genuine beauty."

These are words for us financial professionals to live by.

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