Moving From Making Money to Creating Wealth

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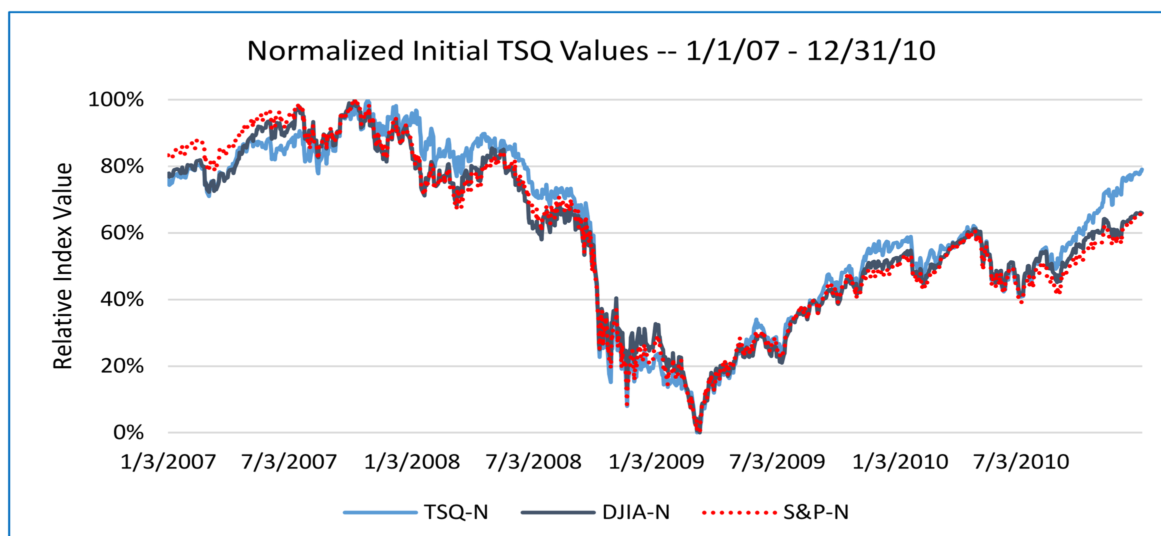
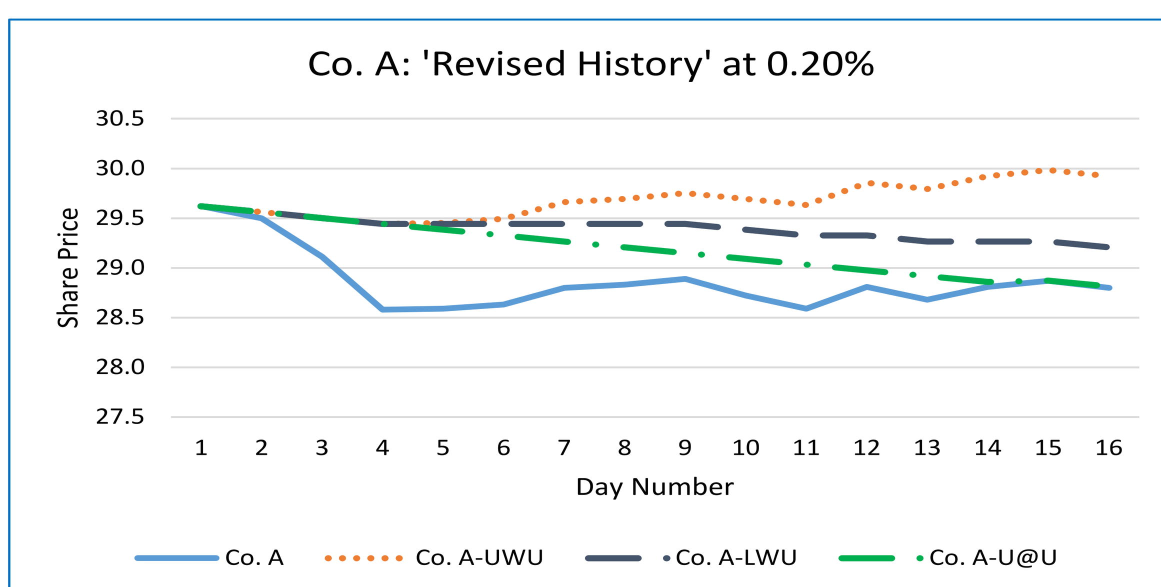
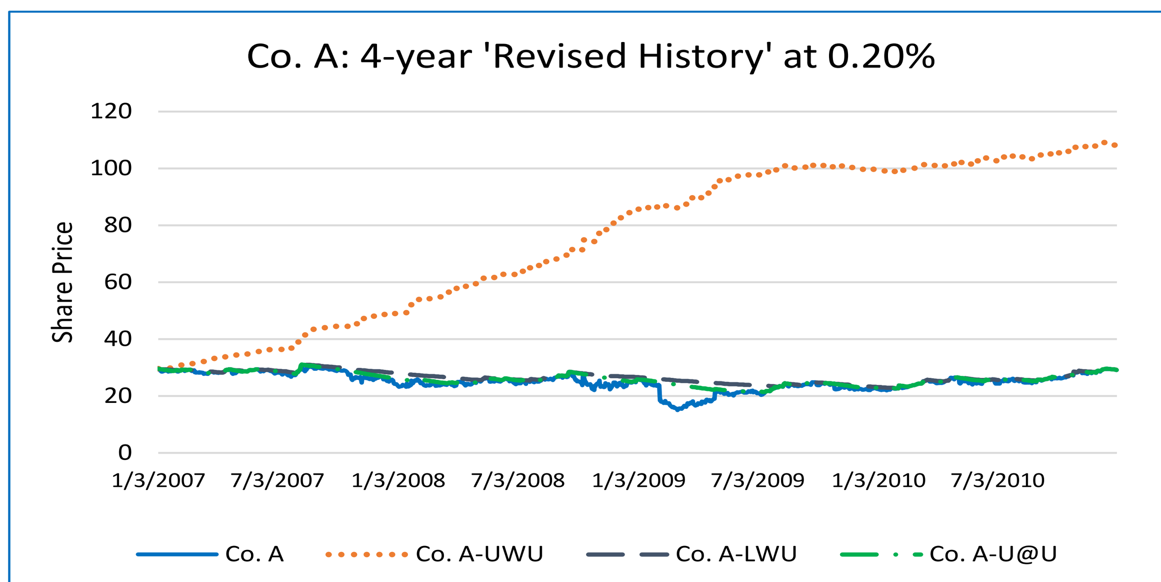
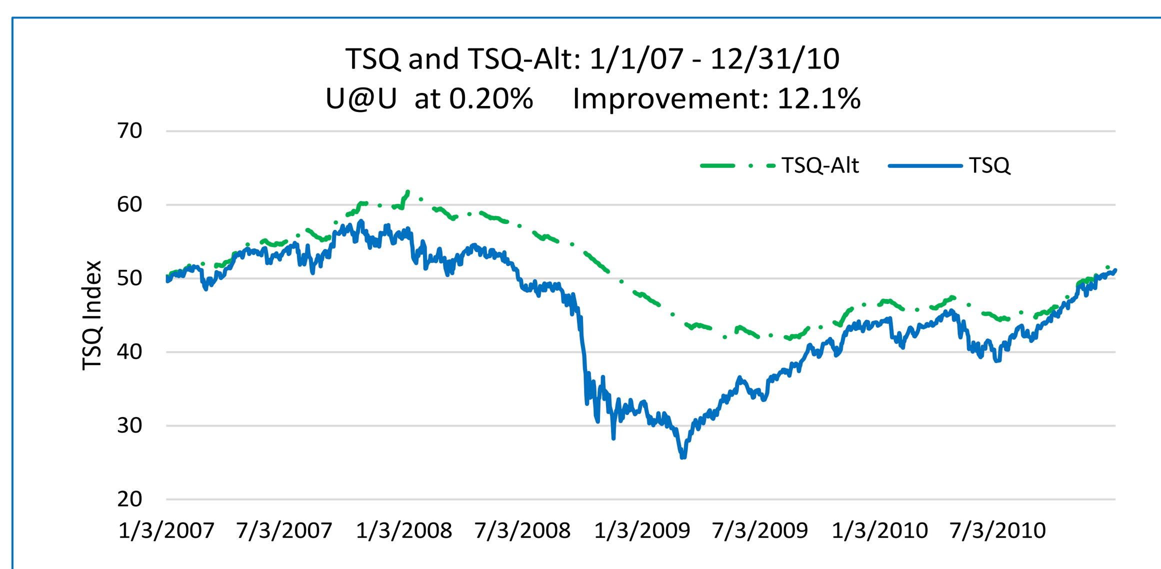
Introduction:

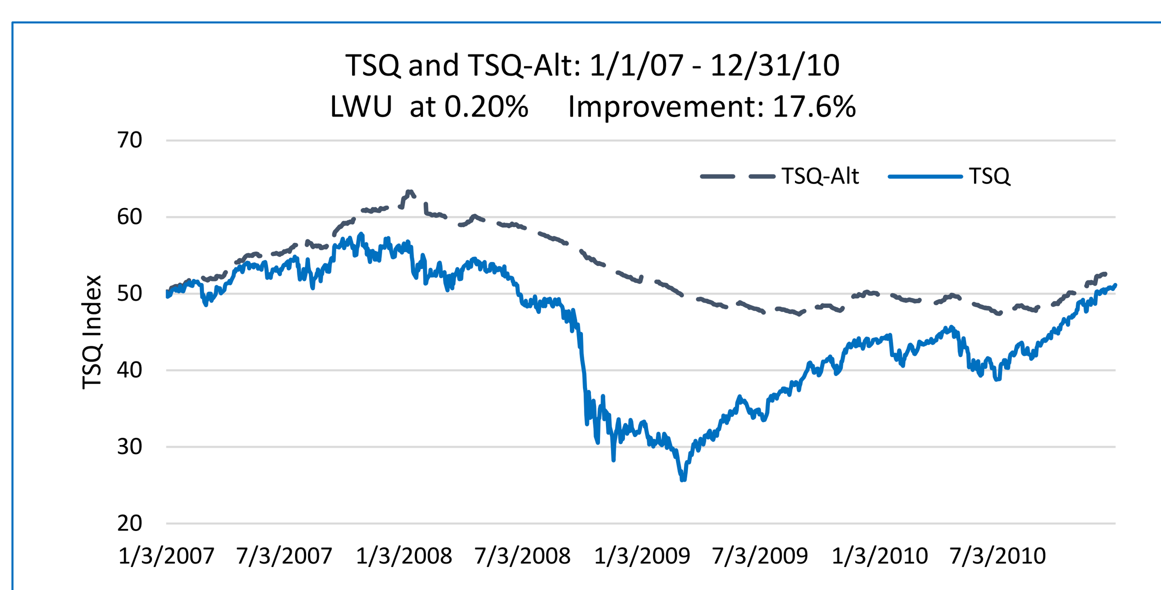
What would happen to American capital markets if a stock's price could only fall a small amount in any 24-hour period? What if there were no after-hours trading? A new stock index is created using 36 random stocks traded on the NYSE that mirrors the DJIA and S&P and has those rules imposed upon its component stocks. It turns out that if that were the case, the "Great Recession" would probably not have happened.

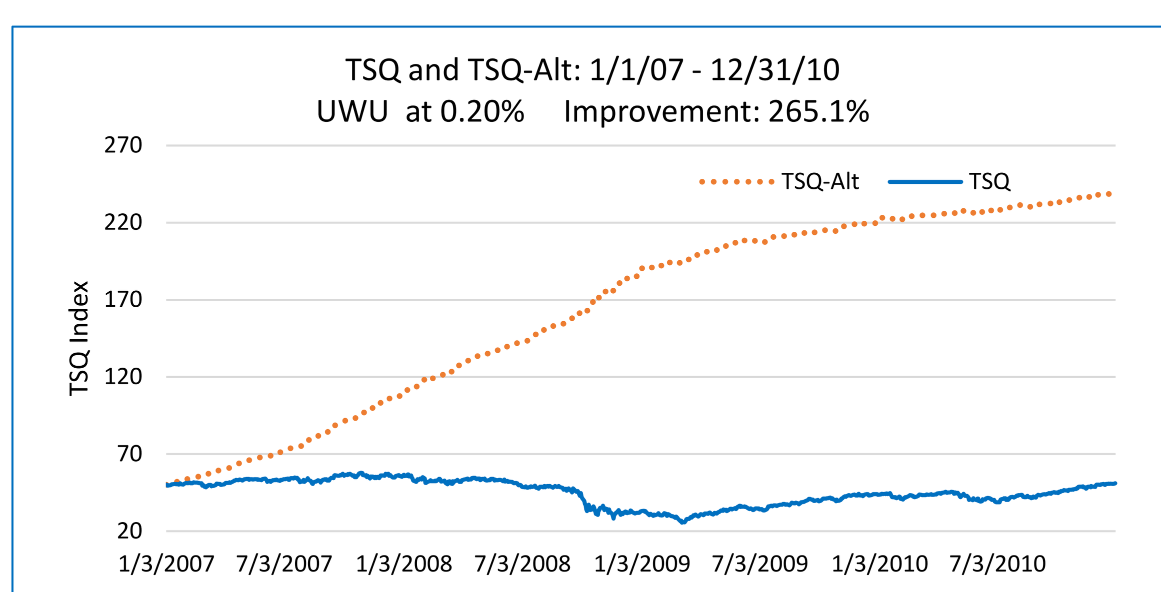












Discussion:

After choosing 36 random stocks from the 3,000+ stocks traded on the NYSE, we calculated an index for this "T²" or "TSQ" index by weighting the price by the number of outstanding shares, as $TSQ = \sum \frac{S_i}{\sum S_i} P_i$. We then plotted TSQ, DJIA, and S&P as percentages of their maximum and minimum values from 1/1/07 through 12/31/10. **←Figure 1** shows that all three indexes behaved almost identically, giving us confidence that what we did to TSQ has relevance for the major indexes. (We believe that *any* random selection of stocks would behave substantially the same.)

It is not possible to know what might have happened with new trading rules, but **←Figure 2** illustrates three possible scenarios. First, the stock's price drops are limited to 0.2% per 24 hours. The stock's price is then assumed to rise the same amount on the same day as historically (UWU). This is the dotted orange line. The second scenario is that the stock may not have risen as it did in the past because its price would have been higher and the stock may not have been perceived as a bargain. When its price rose historically, the second scenario keeps the price level; it doesn't go down (LWU). The third and most conservative possibility is that the stock will only rise when its new price reaches the same level at which it actually sold in the past U@U).

When the all three scenarios are calculated for the entire 4-year period, it can be seen that the first scenario is quite optimistic, and we believe, only possible if, without the ability to short a stock in a short time frame, the answer to the question "Where else will the money go?" is "Quality stocks and, especially, new ventures." **←Figure 3** shows that the two more conservative possibilities eliminate the deep drop in all the markets in late 2008 and early 2009. The dramatic increase in price from the first scenario obscures the fact that the recession was effectively eliminated by even the most conservative scenario.

When applied to all 36 stocks, the index behaves as the sample stock. Figures 4, 5, and 6 show the effect when the trading cut-off point is 0.2% for each of the possible alternative behaviors.

←Figure 4 shows that for the most conservative scenario, a 20% rise through 2007 would have been followed by a 30% fall over the following year-and-a-half. In fact, it is not possible to say what would have happened had our rules been in place from 2007 through 2010. Knowledge that stock prices couldn't fall precipitously may have fundamentally altered investors' mindsets such that they'd have taken long-term short positions in the reckless offenders and left the rest of the economy unaffected.

←Figure 5 shows the middle scenario, and for this one, the index never falls below its opening value on January 1, 2007.

Conclusion:

Our thesis is that by preventing stock values from falling precipitously, stock selection will be a decision based on quality rather than on anticipated price movement, thus transforming markets from a casino for the few to a stable wealth-creation machine for the many. Such a rules change will also inure our capital markets from emotional shocks due to non-economic disturbances in politics and Nature.

We also acknowledge that the "get mine *now*" mentality of those currently prospering will never allow anything like this to happen. We can only hope that eventually a more enlightened self-interest based on long-term prosperity for the vast majority is a more desirable personal future than is hoarding a vast unspendable fortune in a gated community.