Shrinking Ameri

BY THORNTON PARKER

The divide between America's wealthiest and the middle class seems to be growing daily. The rift threatens to get even greater when the baby boomers start to retire.

THE IDEA OF A GROWING WEALTH GAP IS CONTROVERSIAL, but Treasury, Census Bureau, and other data show clear trends of wealth and income growing faster for the country's richest few than for the broad middle class. Three major drivers of those trends are globalization, the misuse of corporate stocks, and retirement plans that depend on stocks, and they interact in largely unrecognized ways.

These drivers are like Trojan horses. Each is explained as being good for the country, but individually and in combination they're transferring money directly from the middle class to the rich; distorting the economy by reducing opportunities for millions of Americans to earn middle-class incomes; and rewarding the financial services industry. In conjunction with recent tax cuts, the drivers are helping to create an enduring aristocracy of wealth and political power.

Globalization

The basic argument for globalization is that a country can do best by concentrating on fields in which it has natural advantages and by trading with other countries that have complementary

ca's Middle Class

advantages in other fields. This makes sense, and history shows that it helps the sum of all economic activity grow.

But rarely are the growth and its benefits distributed uniformly. Changing economic patterns are usually most profitable for the changers who tend to be the most powerful. It often hurts those who did well or at least adequately before and have trouble adapting to the new patterns.

This is happening to many middle-class Americans who have limited or obsolete skills and whose jobs are being eliminated, downgraded, or transferred to countries that pay far less. America's consumers do benefit from lower costs, but the biggest winners are large investors and corporate executives who promote and manage the changes.

Workers' Retirement Plans *vs.* Jobs

Americans are encouraged to save more for retirement and use the money to buy stocks or stock mutual funds that are expected to grow several times faster than the economy. As a result, pension systems, defined contribution plans, mutual funds held in retirement plans, annuities, and IRAs now own over half of the domestically owned stocks traded on U.S. markets. Most of those stocks will have to be sold at inflated prices to pay retirement incomes, but there is no accepted explanation of who will pay those prices when baby boomers retire.

There is another problem: As retirement savings flowed into pension and mutual funds, the fund managers were pressed to make the money grow. The managers passed the pressure for growth on to companies.

Companies responded by cutting costs, downsizing, merging, laying off domestic workers, moving jobs overseas, implicitly supporting illegal immigration, abandoning their communities, ignoring the environment, promoting globalization, and becoming global themselves. This is still going on.

Pressure for rapid stock growth has forced public companies to adopt short time horizons and avoid investments that could provide middle-class jobs but not lead to quick profits. Ironically, retirement plan stock purchases have led directly to the loss of domestic jobs that began in manufacturing and then spread to other industries.

Retirement Plans and Corporate Insiders

Contrary to the claim that buying stocks provides capital that companies need to grow, Federal Reserve data show that companies have retired more stock (in dollar terms) than they issued since the bull market began in 1982.

Households were the primary stock sellers, and retirement plans were the primary buyers. Analysis of the data shows that the sellers had far higher returns than the buyers, This must have been due to the households of corporate insiders.

Insiders get large blocks of stock at low or no cost directly from companies, which they may keep or sell as cash crops. Many of the stocks they sold at market prices were bought by retirement plans, and the profits were attributed to households.

Retirement plans make a market for insiders' stocks, buying many of the shares they sell and helping to set the price of the shares they keep. When retirement plans buy insiders' stocks, they add to the wealth gap by transferring money from the middle class to the richest people in the world.

Stocks and the New Business Model

Under the traditional way of doing business, investors and executives were rewarded from profits after they'd built companies with sound businesses. A new business model now shortcuts that time-consuming process. It uses stocks to reward founders, early

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investors, executives, and maybe other employees well in advance of future profits, which may never be earned.

The new business model transfers money from stock buyers to insiders. Most technology companies and much of the NASDAQ are based on the new model, which has been extended to mature companies through the use of stock options.

As the *Forbes* lists of wealthy people show, insiders use stocks and the new model to create huge fortunes that middle-class savers, who must buy their stocks on public markets, could never do.

Under current financial, business, and government policies and practices, the country appears headed toward a social and financial meltdown that will be like the Iraq War—easy to start but with no satisfactory way to end.

How They All Interact

Few people other than those who benefit the most understand how these elements work as a system to transfer wealth from the middle class to the very rich. Two corporate examples and two data sources help to explain the interactions.

Before Microsoft went public, it issued 45 percent of what would become its outstanding stock after its IPO to Bill Gates. Large blocks were also given to other founders and early investors. The company did not need money—the IPO was intended to set market values for the insiders' holdings. This worked, making Gates and many others rich overnight. At one time, there were an estimated 10,000 "Microsoft millionaires," and Gates has been selling shares gradually ever since.

The stock became popular, and after it was included in the S&P 500 Index, every retirement plan that was tied to or measured by the index had to own it. Statistically, more than a fifth of all Microsoft shares held by retirement plans were sold into the market by Gates himself, who *Forbes* says is the richest person on Earth. After his first sale, all his proceeds, many of which came from retirement plans, were profit.

A similar but more spectacular example is Google. During its IPO, it sold shares equaling about one-twelfth of the shares it had already issued to insiders, many of whom worked for but had invested little or no money in the company. When all shares were treated as being worth the IPO price, the founders immediately became multi-billionaires. As the price went up, insiders' paper fortunes grew, and they are systematically converting some of their shares into cash. Workers' retirement plans are providing much of the cash.

Each week, the *Wall Street Journal* publishes its "Insider Trading Spotlight," a summary of insider stock buying and selling by company directors, officers, and holders of large blocks. It doesn't include grants or options transactions. During 2006, insiders sold more than $57.5 billion worth of stock, or 37 times as much as they'd bought. For technology companies, the ratio was 90:1. The numbers vary over time, but the pattern is consistent; insiders create fortunes by getting stocks directly from companies at little or no cost and selling for large profits, often to retirement plans.

Forbes publishes annual lists of the country's and the world's wealthiest people. The wealth estimates are based largely on stock holdings. Even a cursory review of the lists shows that most Americans made their fortunes quickly, which they could do only as corporate insiders.

The recent tax cuts on dividends and capital gains are touted as being good for middle-class investors, but they primarily benefit wealthy insiders. Most of the stocks and mutual funds in middle-class retirement plans already had special tax treatment.

Eliminating the inheritance tax is justified as necessary to save family farms and small businesses, but that too is deceptive. The real purpose is to let insiders, the richest people in the country, pass their fortunes and power on to their heirs and perhaps create dynasties.

The End Game—Implosion?

President Bush says that as baby boomers age, there will be too few younger workers to support them through Social Security as it's structured now.

But retirement plans can get money to pay retirement incomes in only three ways: by transferring it from workers (as Social Security and many pension plans do); by receiving interest or dividends paid by organizations that issued the securities they own; or by selling their securities.

Retirement income is like electric current; it's dynamic and always moving. It comes only from dynamic sources and can't be stored in large quantities. Salaries and wages, which are dynamic, provide more than two-thirds of the U.S. national income. Unless the money that retirement plans will use to pay aging boomers comes from foreign sources, it will have to come primarily from the salaries and wages of the same younger workers that President Bush says can't sustain Social Security.

When boomers retire, plans that depend on stocks will have to sell their stocks to tap younger workers' incomes. But while the plans will be selling, insiders will also be selling to convert their paper gains into cash. The surge in the supply of stocks offered for sale in relation to the limited purchasing power of the younger workers appears to be a formula for a sustained bear market and perhaps a depression in the next decade.

The country is conducting a massive experiment with its stocks-for-retirement cycle. It is now in the front or build-up half of the cycle, but no country has ever shown that the complete cycle, including the back or liquidation half, can work for a large segment of a singularly large generation. In fact, recent academic studies show just the opposite.

For generations, wealthy people have used stocks to pass wealth down to their heirs, as the tax laws have encouraged. Now, the financial services industry, many economists, and political leaders urge boomers to save and buy stocks because "over the years, stocks have returned more than other types of investments."

But there has never been a published due diligence analysis or feasibility study that explains how stocks can be used to reverse the traditional flow and pass money from workers up to the middle-class retirees of a singularly large generation. That has never been done before, and history isn't a guide to unprecedented events.

In addition, few boomers are saving enough to hope to retire. They'll have to work into their later years. To do that, they'll need dependable jobs with adequate pay and benefits, even if their skills are obsolete and their capabilities are declining. But those are the types of jobs that public companies are eliminating in order to inflate stock prices.

Millions of aging boomers will have to compete with younger workers, recent immigrants, guest workers, and low-paid workers in other countries. It's hard to see how domestic and global competition to reduce employee earnings will let large numbers of Americans, three-quarters of whom aren't college graduates, sustain what has been the middle-class standard of living.

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Winners and Losers

Many dismiss attempts to guide the economy as "industrial policy" that, they argue, can't work as well as unfettered markets because it picks winners and losers. This ignores the history of how the country was built. And by adopting what are said to be market-led approaches to economic growth and providing for the aging, the country has already picked winners and losers.

The winners are corporate insiders; those who manage other people's money; those who can move their interests quickly to anywhere in the world; those who inherit their fortunes; and those who see what's coming in time to prepare for it.

The losers include most people whose jobs can be eliminated or done by those who are paid less; those who hope their stock-based retirement plans will sustain them in their later years; and those who don't see what's coming in time to protect themselves.

This is a path to disaster.

How Stocks Really Work

Schools of business and economics ignore the two most basic elements of the market that set stock prices—the supply of stocks offered for sale and the demand or offers to buy them. There is also a huge gap between what some academics know and what middle-class savers know. Savers are told to buy stocks to pay for their retirements, but most of their information comes from the financial services industry and media that profit from their actions. The future of boomers, younger workers, and the country rests on ignorance and misinformation.

Stock or equity has become a form of money that companies use to reward investors, buy assets, and compensate employees and executives. Creating it by issuing large blocks of shares to insiders and owners of companies that are being acquired is like counterfeiting or simply printing money.

The effects of this uncontrolled money are ignored in national income accounting. One reason for the low national savings rate is that while some people are saving and buying stocks, retirees and insiders are selling. When the sellers spend their proceeds for consumption, the net effect is lower net saving. Stocks hide the transfer of wealth from the buyers to the sellers.

Seven important aspects of stocks in retirement plans that few people understand are:

- Stocks are promoted as a way to store income, but this is deceptive. Retirement income is a dynamic flow, and large amounts of it cannot be stored. Stocks appear to store it because the eventual source of retirement income flow is never mentioned—the future buyers.
- Stocks turn retirement plans into pyramid or Ponzi schemes by promising returns that grow faster than the economy, but they will pay the returns with money taken from future buyers, not with revenues produced by companies.
- "Total returns" is a deceptive measure. Total returns come from three sources—dividends, portfolio value adjustments based on recent trade prices, and eventual buyers. Each source has unique features that must be analyzed separately. Bundling them into total returns is like wading across a river with an average depth of four feet. You don't see the holes.
- Capitalized value or market cap is a poor indication of a company's size because the new business model inflates it by creating and pricing many more insider shares than were sold to finance the company. As Google showed, a small company can appear to become a giant overnight when all of its shares are treated as worth the recent market price.
- It's a serious accounting error to increase the value of stocks in retirement portfolios when market prices rise and make them seem like money in the bank. As retirees learned during the 2000-2002 decline, portfolio values that are based on market prices are phantom wealth that can just vanish. Phantom wealth is a major component of most retirement plans.
- It's important to know—but hard to learn—who are the major sellers and buyers that set the prices of a stock. Few people know that retirement plans have been the primary buyers that helped drive the bull market that started in 1982 when 401(k) plans came into being. With the new business model, workers give their retirement savings to insiders only to have the insiders limit future price increases by selling and competing when the workers' stocks are sold for retirement income. Promoters say that stock buybacks are good for the retirement savers, but they actually hurt those savers if they effectively transfer companies' retained earnings to insiders who are selling.
- Promoters don't explain that outside of very long-term trends, for each party that wins with a stock trade, there is a loser. After a trade, the price usually changes. Those who sell before it goes up are losers, as are those who buy before it goes down. Overall, the chances of winning are about fifty-fifty.

Until middle-class workers learn these and other important facts, they're pigeons waiting to be caught by financial raptors. But no institution, industry, or government agency is teaching them.

Measuring What Stocks Do

The case for using stocks in retirement plans is often based on what's said to be the history of stocks. One popular view is the 80 years that began in 1926 as measured by the S&P 500 Index. But the Index wasn't developed until 1957. Data for prior years are Standard & Poor's backward projections of what the index might have shown if it had existed. Moreover, few investors could use the index as an investment instrument until Vanguard introduced its Index Fund in 1976 because of commission costs. The first 50 years of the 80-year history are statistical fiction—they just didn't happen. And had the index been used, the history would have been different.

Two other problems with stock indexes that few people understand are:

- They're biased toward stocks that are growing while ignoring those of companies that appear to be declining. One reason why the Dow Jones Industrial Average just passed its previous peak is that 7 of its 30 stocks have been replaced since 2000. It no longer includes Allied Signal, Chevron, Kodak, Goodyear, International Paper, Sears, and Union Carbide, but someone still owns them. Larger indexes haven't shown the same growth because their samples couldn't be changed so easily.
- Using an index as both an investment instrument and a measurement instrument leads to measurement errors. For example, portfolios that are tied to the S&P 500 must own particular stocks just because they're in the index. This creates demands for those stocks when savings flow into portfolios and is like heating the thermometer to roast the turkey. But it works both ways, and it will add to the supply offered for sale when the portfolios must liquidate.

Productive or Parasitic Investing?

America now has a "do as I say, not as I do" economy. Members of the middle class are told to save and buy stocks so that companies can grow, create jobs, and help the economy grow. (They're also urged to borrow and consume more, but that's another story.) Instead of using their savings for productive investments to build the producing side of the economy, however, managers of pension, mutual, hedge, and private-equity funds press companies to cut costs, merge, downsize, and buy back their stocks to increase stock prices.

These funds are parasites that benefit from productive investments that others have made without contributing anything. Just as there is no explanation of how stocks can pay boomers' retirement incomes, there is no explanation of how parasitic investing can help American companies and workers prosper while the most rapidly growing countries are using their capital to build the productive sides of their economies.

In addition to competing in the global economy, waging a war that few of us understand, and dealing with record amounts of debt, America will need to provide adequate jobs for its people, change its energy base, upgrade much of its infrastructure, and modify its health care system during the next few decades. This will require historic amounts of long-term, productive investment that the financial system, which concentrates on short-term parasitic investments, doesn't provide today. ●

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