Testimony
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You have called this hearing to ask how pension funds can avoid losing money in the stock market. Many investors lost a lot of money in Enron and in other corporate disasters.

There is one clearly wrong answer. It is the answer that *seems* like the obvious *right* answer.

"Don't buy losing stocks" sounds good, but it doesn't work. Big pension funds will not—repeat will not—avoid losing money in the stock market by trying to pick winners and sell or avoid losers. The more a pension fund tries to do this—the more it buys and sells—the more it loses. Over three-quarters of managers lose money when they try to do well by active buying and selling. With large amounts of money you cannot, over time, avoid the losers. Instead, you aggravate losses by incurring large fees. I am happy to explain this key point further in plain English during the question period if you want. It takes two minutes and I only have five. I'll just say for now that it has been demonstrated with ample data that large funds that try to avoid investments in losing stocks by hyperactively managing their money fail to avoid the losers and instead incur large trading costs on top of losses.

Pension funds, in other words, should not have been trying to avoid Enron by hyperactive management. This is why most of the best-managed pension funds in the country had some Enron stock. In all cases of which I am aware, the amount of Enron stock the funds held was tiny compared to overall assets.

But that doesn't mean that something can't be done to reduce losses from future Enrons. A number of things can be done. Rather than reduce the chances of particular funds holding rotten companies' stocks, we should reduce the numbers of rotten companies. This is the better approach and it happens to be the only approach you can promote legislatively.

Our antiquated securities laws and conflict-ridden oversight systems give us poor quality information and prevent us from acting effectively on information we do get. Many companies like Enron would not have had to implode if owners had gotten key information and been empowered to act on it. Owners hate losing money; they don't need to be encouraged to act. And it doesn't cost taxpayers anything when owners spend their own money to prevent fraud and encourage good corporate behavior.

But the information investors get is flawed, incomplete and sometimes grossly misleading. And additional laws prevent or severely inhibit investors from acting on the information they get. Combine these two and you get Enron. Global Crossing. Xerox. Rite Aid. Sunbeam. Waste Management. MicroStrategy. Cendant. And on and on.

The problems have been obvious for decades before Enron. If you don't require companies to disclose stock option plans, and if you don't require companies to let shareholders vote on stock option plans, if you don't require companies to expense stock options, you get runaway compensation that turns companies into Ponzi schemes.

If you allow companies to hide their directors' financial conflicts, if you allow companies to hide their debt just because a tiny portion of its equity is held by someone else, if you allow people who want wiggle room to write accounting standards, if you let brokers vote when shareholders do not, you will get more Enrons.

If you saddle shareholders with restrictions that make it look like the government is overseeing pedophiles rather than property owners, if you maintain disclosure requirements that give company managements ammunition to sue shareholders who question them, if you fail to prosecute individual wrongdoers and instead levying corporate fines that hurt victims but not wrongdoers, you will get more Enrons.

Worse yet, you will get markets that start to slip. All great societies start to crumble at some point. Many do when special interests start to dominate. The fact that we've had a good run of it doesn't mean we will continue to do so. We need accurate disclosure of company financials. We need accurate disclosure whenever officers' or directors' or auditors' interests are not aligned with shareholders. But we need more than disclosure: being told we're being taken to the cleaners is not helpful unless we can act to prevent it. I am submitting previous testimony of mine in which I catalog what needs to be done.

The key concept is this. Wall Street and some executives are enriched when shareholders bet on the horses. Betting, indeed, is strongly encouraged by those who profit at shareholders' and employees' expense. But while betting on the horses is encouraged, *training* the horses is actively discouraged. A significant collection of laws and regulations make it nearly impossible for shareholders to act like the owners they are. These laws and regulations are *not* accidental. There has been a major power struggle over the past many decades over who controls major companies, and, by and large, directors and managers have won.

Over time, the fact that shareholders are encouraged to do a lot of buying and selling and are discouraged from acting like owners has meant that shareholders are betting on slower horses. If everyone bets on the horses and no one trains them, our economy will suffer. If our regulators do not exhibit leadership to correct these problems rather than put Band-Aids over them, capital flight will start to occur.

I urge you to pass legislation and encourage regulation that gives shareholders both the information and the tools they need to oversee America's big corporations. This is America's grocery money at stake and you are the ones who can take—or not take—the right actions to protect it. Lean on regulatory bodies who don't demonstrate leadership. Assist training, discourage betting, and you'll create a more consistent field of thoroughbreds.