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Equity mutual fund losses wiping out Americans' savings

by Richard Freeman

In the recent period, Americans opening letters from investment houses informing them about the performance of their mutual funds, stock portfolio, or pension plan, have had shocking news: Instead of the usual monthly gains, they are incurring heavy losses. Indeed, this will increasingly be the case in the months ahead.

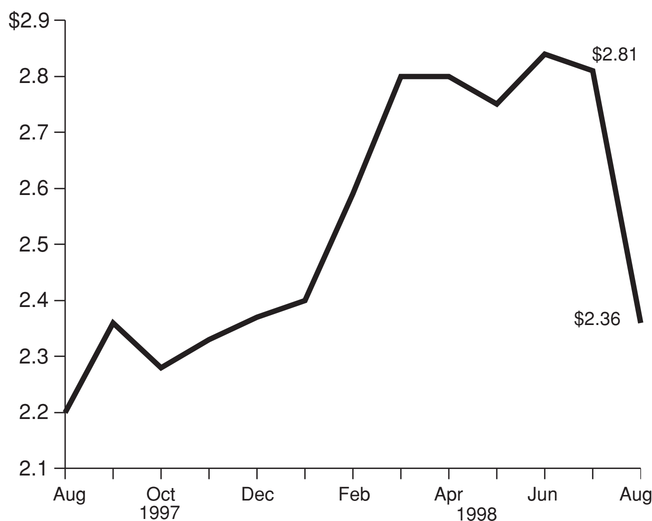
The latest example is the reported return of mutual fund equity funds (mutual funds that invest in stocks) for August (the latest available month), which was reported at the end of September by the Investment Company Institute, the mutual fund industry's trade group. As **Figure 1** shows, at the end of July, equity mutual fund-held assets were worth $2.81 trillion; by the end of August, assets had fallen to $2.36 trillion. Some $450 billion in assets—15.9% of the total—vaporized in one month. Of the $450 billion drop, $11.2 billion was attributable to the withdrawal by households of money from equity mutual funds; $439 billion was attributable to the fall in equity values.

For the 26 million U.S. households that own equity mutual funds the meaning was unmistakable: 15.9% of their holdings had gone up in smoke. In the coming period, as the world financial disintegration accelerates, the conditions exist for the teetering, vastly over-valued U.S. stock market to free-fall again. A repeat of the loss by equity mutual funds of $450 billion, or even double that—say, nearly $1 trillion—in a month, is not only possible, but likely.

The effects of the downward spiral in stock values will be devastating, on a scale which the American family has never experienced. A social explosion could ensue.

The American family is vulnerable because it owns such a large amount of stock. Over the course of the last 15 years, American families, drawn in by an orgy of stock speculation built on pyramided leverage, acquired stocks on a large scale, both through direct stock purchase from stockbrokers, as well as through mutual funds, and through the holdings of their pension and retirement funds. Today, on average, a record 45-50% of the financial assets of the American family, are stock holdings. They accomplished this by going far beyond the normal method of using family savings to pay for stock purchases. Instead, they borrowed heavily: margin loans from brokers; borrowings from credit cards; borrowing against home equity, against the assets in their stock-holding retirement accounts, and so on. They even threw their food and rent money into the market. An unprecedented level of holdings

FIGURE 1
Collapse of value of equity mutual funds
(trillions $)



Sources: Investment Company Institute.

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means an unprecedented level of exposure.

At the same time, Americans forsook their traditional holdings of bank accounts, certificates of deposit (CDs), and bond ownership, to put their money into the stock market, and became dependent on stock income. Now, retired people, children's education funds, and an increasing share of monthly family expenditures, rely on stock income for survival. This is the very income that will disappear.

Recently, the fall of the stock market received a respite. On Sept. 29 and and again on Oct. 15, Federal Reserve Board Chairman Alan Greenspan cut the federal funds rate by one-quarter of a percentage point, so that it ended up on Oct. 15 at 5%. The federal funds rate is the rate at which the Fed can lend 24- to 48-hour money to the banking system. Greenspan made the move in an attempt to provide liquidity to save the collapsing world financial system, which is on the verge of "seizing up," thanks, in part, to the Sept. 23 failure of Long Term Capital Management (LTCM), and the near-insolvency of several American banks. On the day of the second rate cut, Oct. 15, the Dow Jones Industrial Average rose 338 points, and between Sept. 29, the day of the first rate cut, and Oct. 22, the DJIA has risen by 452 points, or 5.6%. But, the Greenspan move is the first step toward a 1921-23 Weimar-style hyperinflation, which will destroy the world financial system. The respite in the Dow Jones will not last long.

We look first at the degree of exposure of American families to the stock market, through pension and retirement funds. Second, we examine the multiple levels of leverage propping up the stock market, which will come unglued through reverse-leveraging, making the overexposure of American families in the market much worse. Finally, we look at some of the large losses so far.

Unprecedented exposure to the stock market

Ownership of stocks through mutual funds is the primary means through which families own stocks.

In 1997, according to the Investment Company Institute, 37.4 million American households owned mutual funds of one kind or another. Since, in 1997, there were 100 million U.S. households, which means that 37.4% of U.S. households owned at least one kind of mutual fund. According to the ICI, 26 million of the 37.4 million U.S. households owning mutual funds, owned an equity mutual fund, i.e., one that invested in stocks. This represented 26% of U.S. households.

(There are three kinds of mutual funds. Aside from equity mutual funds, there are: "bond and income" mutual funds, which invest in corporate, U.S. government, and municipal bonds; and "money market" mutual funds, which invest in a variety of instruments that generally mature in less than one year.)

TABLE 1

American families having direct and indirect stock ownership

Year	Percent of all families
1989	31.7%
1992	37.2%
1995	41.1%

Source: Federal Reserve Board of Governors, Division of Research, "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," published in January, 1997; *EIR.*

However, in addition to owning stocks through mutual funds, households may own stocks through two other principal methods: purchasing stock directly from a broker, such as Merrill Lynch; or, having a pension or retirement plan that buys stocks directly (retirement or pension plans that buy stocks through mutual funds are counted as part of the mutual fund ownership). In the *Consumer Finance Survey* for 1995 (the Federal Reserve Board of Governors conducts this *Survey* once every three years), the Federal Reserve reported rapid growth in the percent of American families owning stock through all means—mutual funds, directly, etc.—since 1989 (see **Table 1**).

EIR estimates that today, 44-45% of American families own stocks through some means. As a basis for comparison, historians have told *EIR* that in 1929, only 7% to 15% of Americans owned stocks.

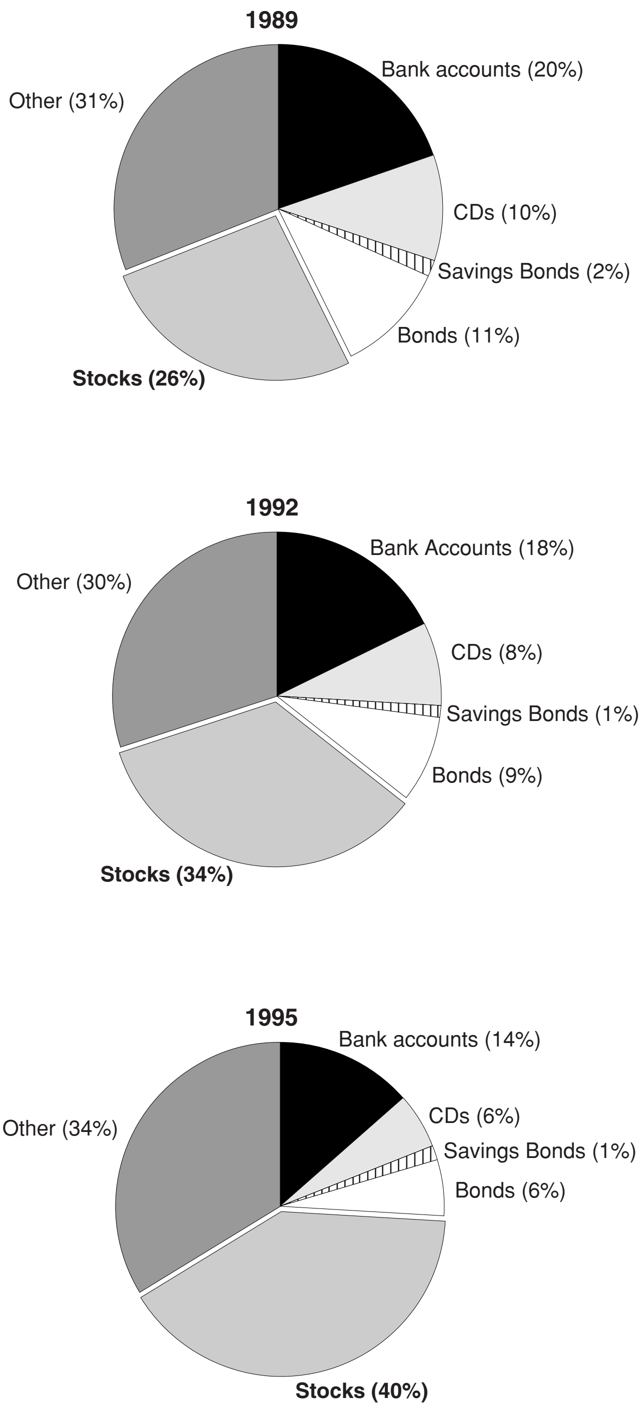
Percent of financial assets in stocks

Another way that family exposure to the stock market increased, is in the percent that stocks constitute of a family's total financial assets, which is represented in **Figure 2.** Notice that during the last six years, the complete reversal in financial asset ownership of the average American family. In 1989, stock ownership constituted 26.3% of American families' financial assets, while the category representing ownership of bank checking and savings deposits (19.7%), bank certificates of deposit (10.4%), savings bonds (1.6%), and other bonds (11.0%), collectively constituted 42.7% of families' financial assets. By 1995, this had reversed: Stocks had leapt to 40.4% of families' financial assets, while the other category representing ownership of bank accounts (13.5%), CDs (5.5%), savings bonds (1.4%) and other bonds (5.5%), collectively had dropped to 25.9% of families' financial assets.

It is likely that in 1998, stocks surged to 45-50% of families' total financial assets, an unprecedented level.

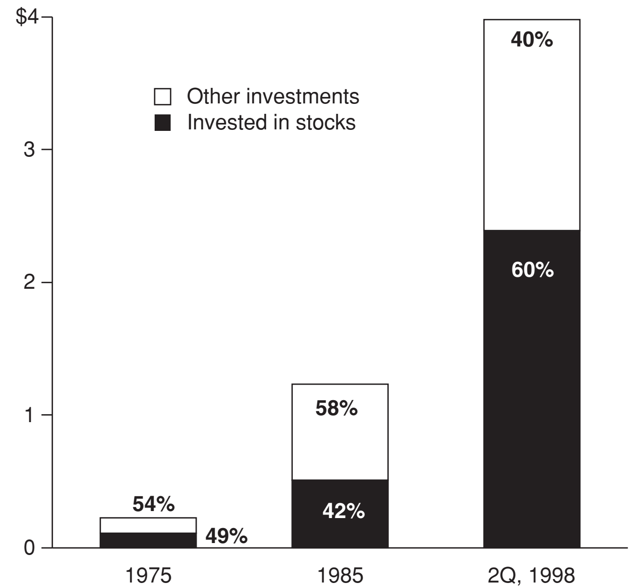
It should be noted that while stocks did appreciate in value between 1989 and 1995, accounting for some of their increase as a percentage of family financial assets, during this same period, individuals only barely increased their savings account holdings, and decreased their checking account and CD holdings absolutely. That is, families effectively disinvested

FIGURE 2
Stocks grow as percent of family financial assets



Source: "Family Finances in the U.S.: Recent Evidence From the Survey of Consumer Finances," Federal Reserve Board of Governors, 1997, Nos. 4 and 6.

FIGURE 3
Private pension assets, showing amount and percentage invested in stocks
(trillions $)



away from bank-based accounts and CDs, and holding of bonds, into stocks. While during a financial disintegration, no financial instrument could be considered safe, bank accounts and CDs are relatively safer than the inflated stock bubble. Yet, families moved in the opposite direction.

Pension and retirement funds

Parallel to the stock exposure of tens of millions of families, is the stock exposure of the retirement institutions upon which tens of millions of retirees and future retirees depend. Over the years, both private pension funds (mostly those plans that employers have set up for their employees) and state and local government retirement employee funds have dramatically increased their ownership of stocks.

Figure 3 shows both the amount and percent of private pension fund assets that are invested in stocks. Thus, in 1975, private pension funds held, out of $225 billion in pension fund assets, $110 billion, or 49%, in stocks. In the second quarter of 1998, private pension pensions held, out of $3.982 trillion in assets, $2.389 trillion, or 60%, in stocks.

Figure 4 shows both the amount and percent of state and local government employee retirement fund assets that are invested in stocks. In 1975, state and local government employee retirement funds held, out of a total of $105 billion in retirement fund assets, $24 billion, or 23.2%, in stocks. In the second quarter of 1998, state and local government employee retirement funds held, out of a total of $2.285 trillion in assets,

FIGURE 4

State and local government retirement assets, showing amount and percentage invested in stocks

(trillions $)

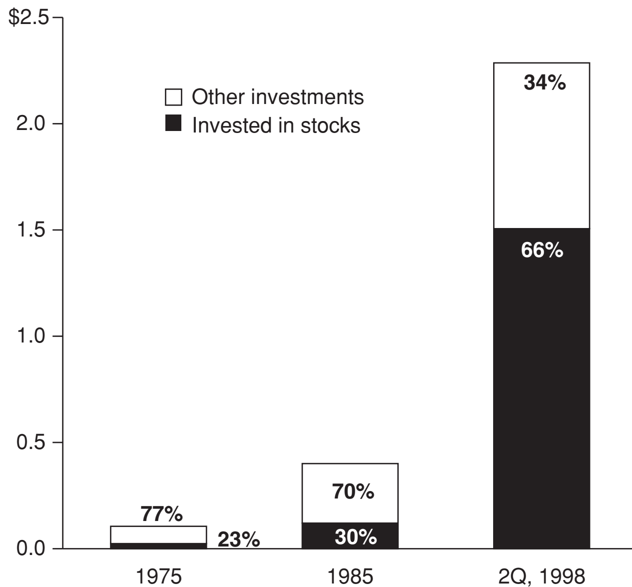
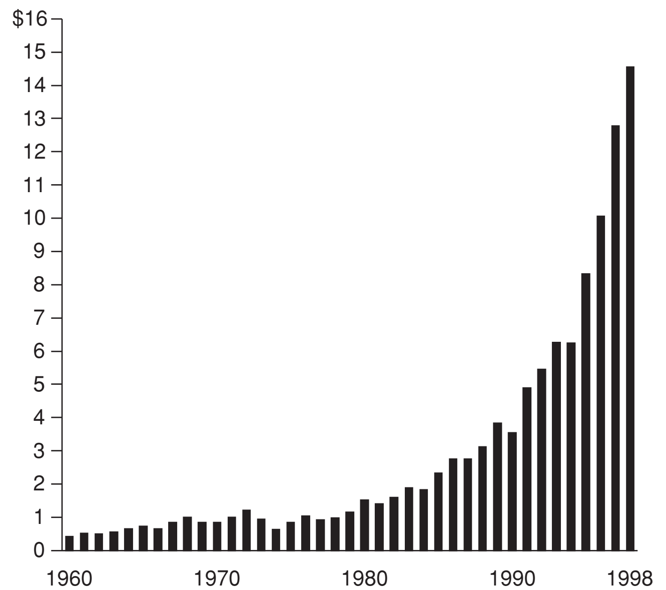


FIGURE 5

Capitalization value of all stocks traded on U.S. stock market, 1960-2Q, 1998

(trillions $)



Sources: Board of Governors of the Federal Reserve System, "Flow of Funds Accounts, Corporate Equities."

$1.505 trillion, or 65.9%, in stocks.

As an example of what may be in store, take the the government employee retirement program run by the Florida State Board of Administration, which covers about 750,000 public employees, and is one of the biggest in the country. In July, the retirement fund had $86 billion in assets. In mid-October, it held only $75 billion. The Oct. 18 *Miami Herald* reported, "In a worst-case scenario, should the stock market collapse and the fund not be able to meet its obligations, the responsibility would fall to the various government entities [counties, municipalities, and districts] whose employees are covered by the fund."

Many Americans block out reality by assuming their retirement nest egg will take care of them. But the fact that pension and retirement funds of all kinds have 60% or more of their funds invested in stocks, means that they stand exposed to another deep plunge in the valuation of the stock market. Those Americans who feel secure, had better think again.

A bubble based on multiple leverage

It is easy to forecast that the stock market and its indices—the Dow Jones, Standard & Poors, Russell 2000, and so on—are headed for a much hotter meltdown, with fearful implications for all those with large stock ownership: The truth is that the U.S. "bull market" starting in 1982, and especially since 1990, did not grow because there was growth in the physical U.S. economy. To the contrary: The real U.S. economy has contracted at the rate of about 2% per year, and the stock market's growth is largely fictitious value. The U.S. stock market has been driven to such greatly inflated heights as a result of the greatest infusion of multiply-connected, mutually self-supporting leverage—debt at high gearing ratios—in American history.

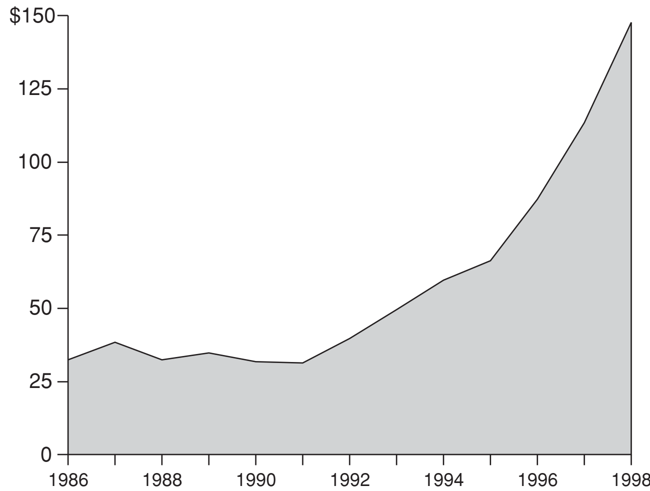
We look at the extent of the leverage, and then how the leverage has driven up the fictitious value of the stock market, demonstrating that, since 1990, roughly three-fourths of the market's growth has been fictitious.

Figure 5 shows the U.S. stock market's capitalization (the market value or share price of a U.S. company's stock, times the number of shares outstanding, carried out for all the shares outstanding of all U.S. companies).

At the end of the second quarter of 1998, the capitalization level stood at $14.556 trillion, which is greater than the combined Gross Domestic Product of all Third World nations, and represents more than a fivefold increase since the 1987 stock market crash.

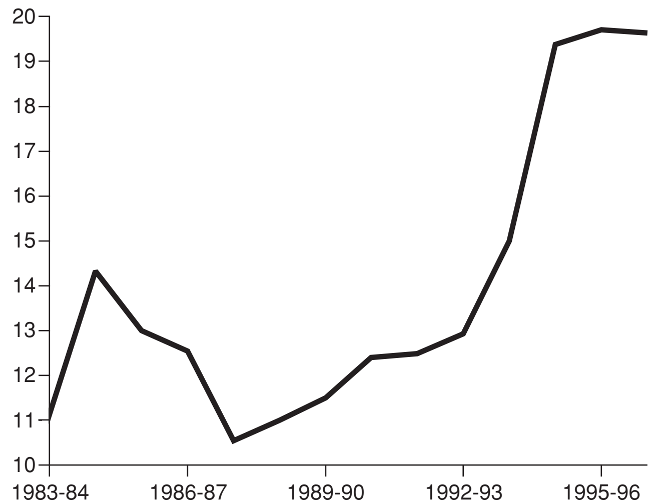
Pushing the market up has been three principal types of leverage, which are interconnected:

FIGURE 6
Margin debt
(billions $)



Sources: New York Stock Exchange.

FIGURE 7
Volume of trading of S&P 500 future contracts, at Chicago Mercantile Exchange
(millions of contracts)



Source: Commodity Futures Trading Commission, annual reports.

1. *Individual margin debt leverage*. In order to buy, say, $100,000 worth of stock, an individual may either buy the stock with his own cash or secure a margin loan from a broker. The initial margin requirement on qualified stocks is 50%. That means that the individual can borrow up to 50% of the value of the stock he wishes to purchase through a loan extended to him by a broker. In this case, the individual can borrow a margin loan of $50,000 to buy the stock in question, and will have to pay the other $50,000 out of his own cash. In return for the margin loan, the broker may require the investor to pledge, as collateral, an amount of stock equal in value to the margin loan.

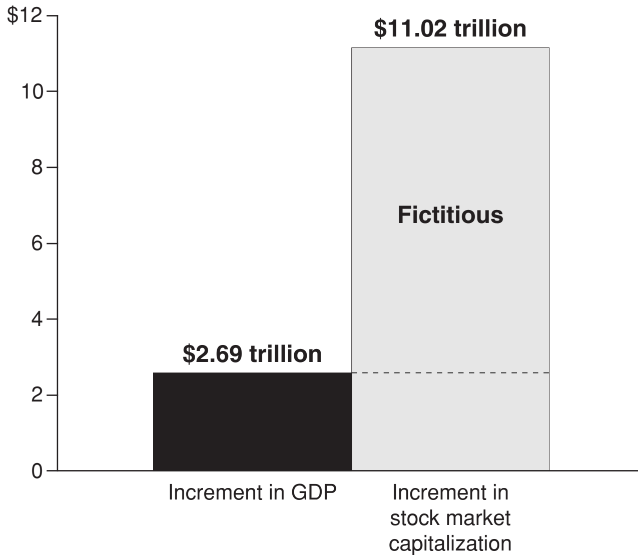
Figure 6 shows that in 1990, the value of broker loans was $31 billion. By 1995, it had doubled to $60 billion. By the end of the second quarter of 1998, it had skyrocketted to more than $147 billion. Raymond DeVoe, Jr., an economist for Legg Mason Wood Walker stockbrokers who has worked on Wall Street since 1949, estimated in a study he released in July 1997 that "the actual level of customers' margin debt could be at least 2 to 3 times reported level." The reason is that individuals have borrowed large sums from many sources other than brokers—on credit cards, against home equity, against stock-holding and individual retirement accounts, and so on—to invest in the market.

2. *Leveraged Buy-Outs (LBO)*. The Leveraged Buy-Out fund, a big tool on Wall Street, transacts the leveraged buy-out with a considerable sum of leverage-borrowing. For example, let us assume that a firm that specializes in LBOs wants to purchase a company for $10 billion. It could borrow $9 billion, and put up only $1 billion of its own funds, a 10:1 leverage. The LBO frenzy surrounding Michael Milken, pales in comparison with today's levels. In 1997, there were in the United States alone $909 billion worth of mergers and acquisitions; a sizable amount of these were carried out through leveraged buy-outs. One means by which an LBO firm can borrow for a takeover is through the issuance of junk bonds (high-yield, high-risk bonds). In 1997, some $120 billion worth of junk bonds were issued in the United States, the first time more than $100 billion worth of junk bonds had ever been issued.

3. *Stock-based derivatives*. Stock-based options and futures, i.e., derivatives, with a leverage that ranges up to 660:1, are the most potentially explosive of the three types of leverage. These derivatives, which were practically nonexistent in the 1970s, have ballooned during the 1990s. These are options and futures taken out against individual stocks, or stock indices like the Standard & Poor 500 index (see **Figure 7**). The purpose of the stock-based options and futures is to both make money, and to manipulate the underlying stocks. Though a single comprehensive figure does not exist, *EIR* estimates that in 1997, about 50 million future and option contracts on stocks and stock indices were traded in America. They would have had a minimum combined value of several trillion dollars.

Each one of these three types of leverage is potentially deadly. Each stock on the stock market may be subject to one or all of these reinforcing types of leverage at the same time. But the same process that pushed up a stock's value to new highs, can send it spiralling down. When reverse leverage kicks in against this multi-connected, multi-pyramided lever-

FIGURE 8
1990 to present: increment in stock market capitalization is only 24% covered by increment in GDP
(trillions $)



Sources: Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board of Governors, "Flow of Funds Accounts;" *EIR.*

age, broker loans will be called in, or investors will have to dump stocks to meet margin calls; junk bonds will melt down, as companies that issued them will not be able to pay interest costs; and the derivatives bubble of futures and options will collapse. Reverse-leveraging in one sphere will trigger reverse-leveraging in other spheres, because the leverage of all of the spheres is interconnected. This will happen at the same time, and the result will be disintegration.

While most "financial analysts" and media have alleged that the purchase of American stocks by foreigners is the prime reason for the rise in the U.S. stock market over recent years, according to Federal Reserve Board figures, during the second quarter of 1998, foreigners owned only 7.4% of stocks traded on the U.S. stock market. That 7.4% is an important margin, but leaves much of the market's increase to be explained. Only *EIR* has reported on the multiply-connected levels of leverage. The reason that "financial analysts" have not reported on the leverage in a full way, is that, were they to do so, they would have to say that there is almost nothing standing underneath the U.S. stock market.

Fictitious value swells the stock market

It is possible to represent through a crucial experiment, the extent to which leverage-driven fictitious value, not economic growth, has propelled the stock market upward, by comparing the growth of stock market capitalization to that of Gross Domestic Product.

Figure 8 documents that from 1990 to the second quarter of 1998, stock market capitalization rose from $3.54 trillion to $14.56 trillion, an increase of $11.02 trillion. During the same period, GDP rose only $2.69 trillion.

To arrive at the fictitious valuation, we know that $2.69 trillion of the $11.02 trillion increase in the stock market valuation since 1990 is covered by a growth of goods and services (as bad as GDP is as a measure of real goods and services, we will accept it for the moment, for the purpose of this experiment). This, then, means that $8.33 trillion of the increase is not covered by any growth of goods and services. This $8.33 trillion, constituting 76% of the $11.02 trillion, means that 76% of the increase of the stock market's so-called "valuation" since 1990, is hot air. Thus, 76% of the stock market's increase in value—$3 out of every $4—is fictitious.

Further, as economist Lyndon LaRouche and *EIR* have documented, since 1990, the real physical economy, inclusive of unpaid costs to maintain infrastructure, as measured by the energy of the system, has declined at a rate of about 2% per annum. Using this more accurate standard, the entirety of the stock market's increase of valuation since 1990, is purely fictitious.

If the multiple levels of leverage that are propping up the market are knocked out through reverse leverage, then that paper value, whether it is 75% or the entirety of the stock market price increase since 1990, vaporizes.

Reverse-leveraging

In the upcoming global phase of financial disintegration, the density of singularities of adverse incidents—derivatives or hedge fund failures, debt defaults, etc.—originating anywhere on the globe, will increase. The danger is that any such incident can set off reverse-leveraging of the stock market.

The U.S. stock market's collapse would either immediately be the trigger for, or have already been triggered by, the reverse-leveraging of the $140 trillion worldwide derivatives market. The combined effects of the reverse-leveragings would set off the biggest financial meltdown in 650 years.

The most egregiously over-exposed investments would be the first to go, such as those of the Oregon State Treasury Department, which has invested more than $2.5 billion in highly speculative Kohlberg Kravis Roberts leveraged buyout funds; or the endowments of Brown, Harvard, Yale, Cornell, and Loyola of Chicago universities, which have currently invested a portion of their monies into hedge funds like LTCM.

But, the reverse-leveraging meltdown would spread with mind-numbing speed to all stockholders. No investment would be exempt.

The 45% of American families that own stocks will quickly learn that the $450 billion loss in equity mutual fund assets for August, may be repeated many times over.