


MICHIGAN 
ROSS SCHOOL OF BUSINESS

How finance reshaped America

Jerry Davis
Columbia Business School
November 3, 2009



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One year later...




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How did we get into this mess?

“There's no question about it. Wall Street got drunk”
G.W. Bush, July 2008

CORRECTION:


The American economy got drunk.
Wall Street was just the bartender.

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Wall Street is Main Street now


- Half of US households are invested in the stock market through mutual funds and 401(k) plans
- Thanks to mortgage securitization and low interest rates, most homeowners with mortgages refinanced them during the first half of this decade
- The **personal savings rate** (employment income – spending) in the US turned **negative** in 2005 for the first time since the Great Depression
- But don't worry:
“The decline in an often-cited aggregate personal saving rate may not be cause for much alarm for retirement preparedness. Much of this decline can be attributed to spending triggered by **wealth increases from capital gains on housing and financial assets.**” (*Economic Report of the President 2006*)

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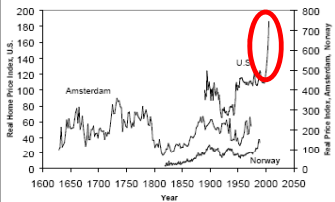
Due to this “wealth effect,” the housing bubble disguised weaknesses in the real economy

- Americans extracted perhaps **\$800 billion per year** in home equity from 2004-2006 – about 9% of US disposable income (Greenspan and Kennedy, 2008)
- Housing price increases fueled economic activity and job creation in retail and housing sectors
 - One-quarter of new jobs created between 2003-2006 were in housing-related industries
 - There were 400,000 mortgage brokers in 2006
 - And 1.2 million real estate agents
 - Roughly \$300B/year went for personal consumption, promoting growth in retail employment

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Was the housing crash utterly unpredictable?



“The magnitude of the current boom is practically **unique in history**, making it difficult to predict what comes next based on historical examples...It's notable that until the recent explosion in home prices, **real home prices in the United States were virtually unchanged from 1890 to the late 1990s.**”

Robert Shiller, March 2006

Figure 1. Real home price indexes for the United States 1890-2005 (Shiller 2005), Amsterdam 1620-1973 (Eichholtz 1997) and Norway 1819-1909 (Eitheim and Erlandsen 2004)

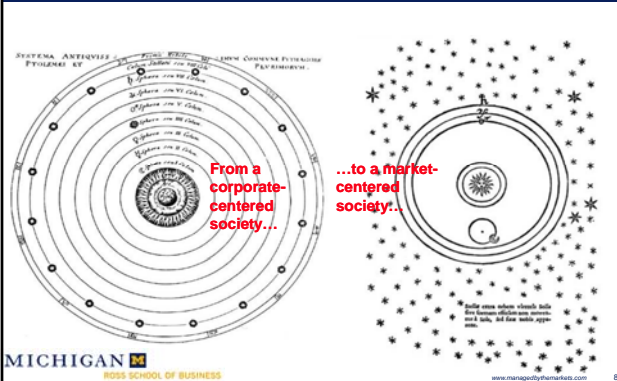
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The mortgage crisis is a symptom of a broader transition in economic institutions

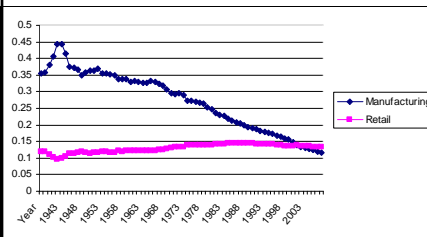
- The US has shifted from an industrial to a **post-industrial economy**
- Employees are **less tied to particular employers** located in particular places
- Households are **more tied to financial markets** through college and retirement savings invested in mutual funds, credit card payments tied to LIBOR, and mortgages ultimately owned by dozens of different financial institutions

This represents a Copernican shift in American society



Post-industrialism (def. 1): “the majority of the labor force is no longer engaged in agriculture or manufacturing but in services” (Daniel Bell, 1973)

Manufacturing employment is increasingly rare in the US



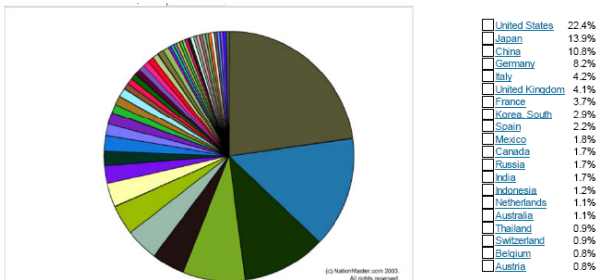
Since January 2001, the US has shed 5.3 million jobs in manufacturing—almost one in three

As of March, more Americans were unemployed than were employed in manufacturing

Proportion of US private labor force employed in manufacturing and retail, 1939-2008 (Source: BLS)

The US still leads in manufacturing value-added...

US global share of value added in manufacturing



...it just doesn't require employees to do it (cf. agriculture)

THE WALL STREET JOURNAL

Lean Factories Find It Hard to Cut Jobs Even in a Slump

By TIMOTHY AEPPLE and JUSTIN LAHART

SPARTANBURG, S.C. -- At a factory here that churns out plastic parts for everything from spray cans to blasting caps, laying off just one worker can be more trouble than it's worth.

The plant, owned by Cleveland-based Parker Hannifin Corp., has become so lean over the past decade that many assembly lines run with only a handful of highly trained workers.

So while mass layoffs have driven the U.S. unemployment rate to its highest in 26 years, Parker and other companies like it are responding to the slump in more surgical ways, mainly by cutting hours and shedding temporary workers.

“Because of productivity gains, every one of my people carries more dollars in sales today,” says Donald Washboretz, Parker’s chief executive. In 2000, the average Parker worker represented about \$125,000 a year in sales. Today, that figure tops \$200,000. “If I need to cut back, I have to cut back fewer people to achieve the same goal.”

Similar trims are taking place at each of Parker’s nearly 300 factories. And to varying degrees, this is happening at thousands of other large and small factories across the U.S.

THE WALL STREET JOURNAL
WSJ.com

OCTOBER 20, 2009

Employers Hold Off on Hiring

By TIMOTHY AEPPEL and CONOR DOUGHERTY

Companies across the economy are holding off on hiring even as the profit outlook improves, amid economic uncertainty and their own success at raising productivity in rough waters.

Hiring always lags behind in economic recoveries, but the outlook this time is worse, many economists say. Most forecasters now expect a prolonged period of high unemployment, even though the government is expected to report next week that the economy grew in the third quarter, after four quarters of contraction. That is sure to frustrate the jobless and could be a problem for the Obama administration.

There are several major factors behind the trend, which is coming on top of sharper-than-expected job cuts in the recession. Many businesses have nagging doubts about the durability of the upturn, attributing much of the recent growth in orders to a move by their customers to rebuild inventories and to government stimulus spending, rather than underlying strength in their markets.

Businesses also face uncertainty about the potential costs of regulatory moves -- such as an expansion of health care and climate legislation -- that could drive up costs. And many employers have learned how to produce more with a smaller number of people than they previously thought possible.

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The largest US employers have shifted from manufacturing to retail and other services

10 Largest US Corporate Employers, 1960-2009

1960	1980	2009
GM	AT&T	WAL-MART
AT&T	GM	TARGET
FORD	FORD	UPS
GE	GE	KROGER
US STEEL	SEARS	SEARS HLDGS
SEARS	IBM	"AT&T"
A&P	ITT	HOME DEPOT
EXXON	KMART	WALGREEN
BETH. STEEL	MOBIL	VERIZON
ITT	GTE	SUPERVALU

Wal-Mart now employs roughly as many Americans as the 20 largest manufacturers combined


Manufacturing Oil Services

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Ten industries with most-tenured employees

Industry	Tenure	Age	%
Agriculture	14	47	1.6
Utilities	13	45	0.9
Petroleum and coal products mfg	11	45	0.1
Forestry, logging, fishing, hunting	10	44	0.2
Electrical equipment, appliance mfg	10	46	0.3
Public administration	9	45	4.9
Transportation equipment manufacturing	8	44	1.4
Beverage and tobacco products	8	38.5	0.1
Paper and printing	8	43	0.9
Primary metals and fabricated metal prods.	7	43	1.4


Source: 2004 Current Population Survey

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Ten industries with least-tenured employees

Industry	Avg tenure	Age	%
Internet publishing and broadcasting	0.5	42.5	0.0
Food services and drinking places	1.5	26	5.0
Private households	2	40	0.6
Retail trade	3	38	11.9
Motion picture and sound recording	3	34	0.3
Rental and leasing services	3	36	0.4
Administrative and support services	3	40	3.3
Social assistance	3	41	2.2
Arts, entertainment, and recreation	3	38	1.8
Accommodation	3.5	40	1.3

Source: 2004 Current Population Survey

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Ties between companies and employees were fraying...

"The whole labor force of the modern corporation is, insofar as possible, turned into a **corps of lifetime employees**, with great emphasis on stability of employment," and thus "membership in the modern corporation becomes the single strongest social force shaping its career members..."

Carl Kaysen, 1956

"If there's one thing you'll learn—and dot-coms have learned it in the last year—is **no one can guarantee lifetime employment...** You can give lifetime *employability* by training people, by making them adaptable, making them mobile to go other places to do other things. But you can't guarantee lifetime employment."

Jack Welch, 2001

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...and the slump is finishing the job

THE WALL STREET JOURNAL
WSJ.com

OCTOBER 19, 2009

Slump Prods Firms to Seek New Compact With Workers

By PHRED DVORAK and SCOTT THURM

The deep recession appears to be drawing to a close, but not its effect on the workplace.


Since the downturn began, thousands of employers have cut pay, increased workers' share of health-care costs or reduced the employer contribution to retirement plans.

Two-thirds of big companies that cut health-care benefits don't plan to restore them to pre-recession levels, they recently told consulting firm Watson Wyatt. When the firm asked companies that have trimmed retirement benefits when they expect to restore them, fewer than half said they would do so within a year, and 8% said they didn't expect to ever.

Changes like these are reshaping employment in America, injecting uncertainty and delivering the jolting news that pay can go down as well as up. The changes are eroding two pillars of the late-20th-century employment relationship: **employer-subsidized retirement benefits and employer-paid health care.**

Even as Congress wrestles with how to extend health insurance to more Americans, and considers putting pressure on employers to offer coverage, some companies feel they have no choice but to pull back -- dropping health plans or weighing such a move.

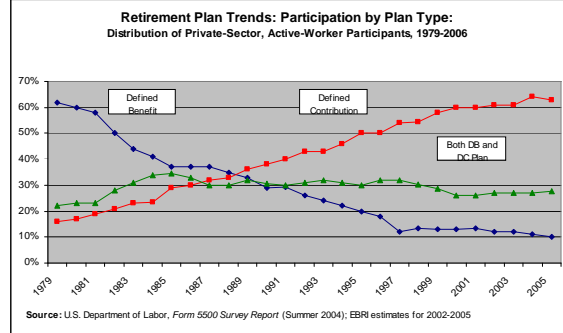
One reason: Although employers pay a smaller percentage of health costs, their dollar outlays continue to rise rapidly, as medical costs do. Employers that offer health insurance spend an average of \$6,700 per employee on it this year, nearly twice as much as in 2001, according to consulting firm Hewitt Associates.

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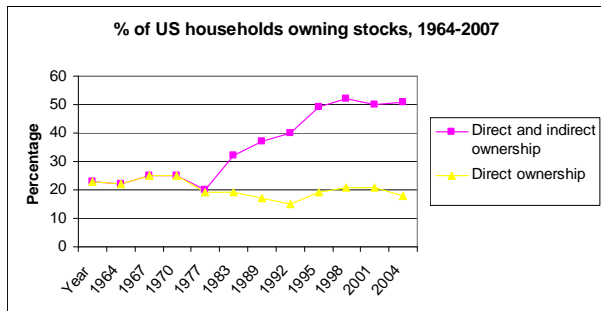
Long-term attachments to employees can be costly...

"Our legacy costs in pensions and health care are an area of significant competitive disadvantage for us... We're now subject to global competition. We're running against people who do not have these costs, because they are funded by the government."
 Rick Wagoner, CEO of GM, Feb. 2006

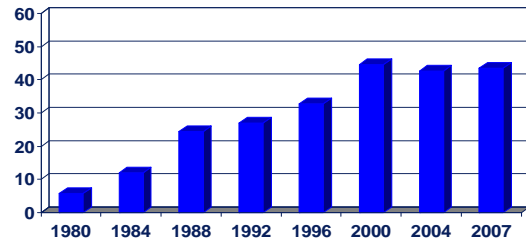
...so most employers have abandoned traditional company pensions in favor of relatively portable 401(k) plans



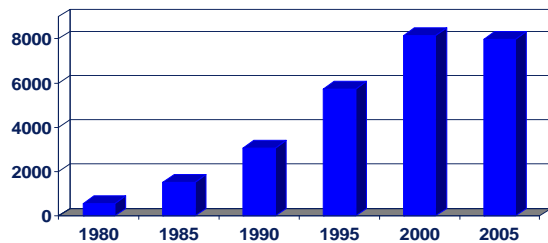
As a result, households became increasingly invested in the stock market during the 1980s and 1990s



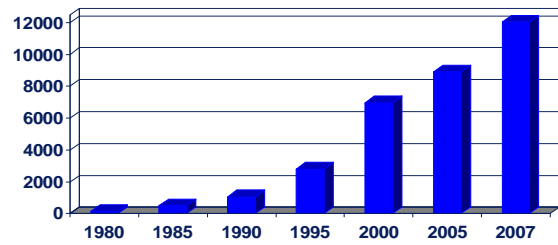
Specifically: investors in mutual funds



There are many more US mutual funds now



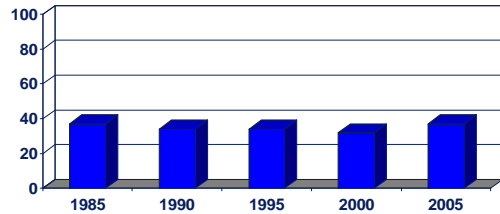
And they gathered a lot of assets



But 'name brand' funds got most of the benefit

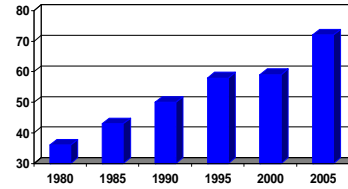


Market share of top 5 fund families



Source: Investment Company Institute 2008 Investment Company Fact Book

Leaving US corporate ownership largely 'intermediated' by a few mutual funds



Corporate ownership by mutual funds

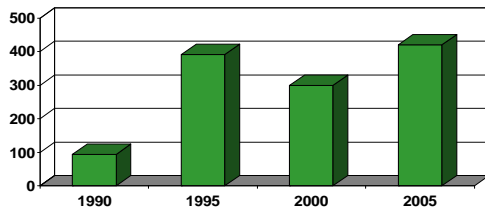
- 1950: 3%
- 1990: 8%
- 2005: 28%

Mean ownership by institutional investors of 1000 largest corporations

Source: Spectrum 13F database, various years

Fidelity is now the largest shareholder of one in ten US corporations

Number of US-listed firms in which Fidelity is largest shareholder



of listed firms in US

Source: Spectrum 13F and 13G databases, various years

Increased ownership by institutions has corresponded to increased devotion to "shareholder value"...

The 1950s

- "A growing number of our large enterprises are run on the model which Owen D. Young proposed twenty years ago, when he was head of the General Electric Company: the stockholders are confined to a maximum return equivalent to a risk premium. The remaining profit stays in the enterprise, is paid out in higher wages, or is passed on to the consumer in the form of lower prices" (Peter Drucker)

The 1970s

- "Hewlett-Packard does not exist to make a profit, it exists to make a contribution" (David Packard, co-founder of HP)

The 1990s

- "We exist to create value for our share owners on a long-term basis by building a business that enhances The Coca-Cola Company's trademarks."
- "Sara Lee Corporation's mission is to build leadership brands in consumer packaged goods markets around the world. Our primary purpose is to create long-term stockholder value."

...and an orientation to share price has induced massive restructuring favoring an "OEM model"

- "We believe the market value of the The Associates is neither fully nor consistently reflected in Ford's stock price. Because the market views Ford as an automotive company, it has not fully recognized or rewarded us for our diversification in nonautomotive financial services businesses." Alex Trotman, CEO, announcing Ford's 1997 spinoff of financial subsidiary The Associates
- "We own all of the intellectual property; we farm out all of the direct labor. We don't need to screw the motherboard into the metal box and attach the ribbon cable... The consumer doesn't care if all the computers were made on the same production line. The only thing that matters is who will stand behind it." Hewlett-Packard VP, explaining why they outsource manufacturing and distribution
- "Wall Street can wipe you out. They are the rule-setters. They do have their fads, but to a large extent there is an evolution in how they judge companies, and they have decided to give premiums to companies that harbor the most profits for the least assets." John Bryan, CEO, explaining Sara Lee's "de-verticalization" program



May 9, 2007

ADVERTISING

101 Brand Names, 1 Manufacturer

The Mass Pet-Food Recall Reveals a Widespread Practice: Many Competing Products Come From the Same Factory

By ELLEN BYRON
May 9, 2007

(See Corrections & Amplifications item below.)

Pet owners have been reeling ever since tainted pet food led to the confirmed deaths of more than a dozen dogs and cats and likely sickened many more.

Some owners were also startled to learn that dozens of competing brands, from discount to premium, are all made by the same company, Menu Foods Inc. of Ontario.

Poisonous pet chow containing melamine from China was made by an Ontario-based manufacturer but sold under dozens of different brand names.

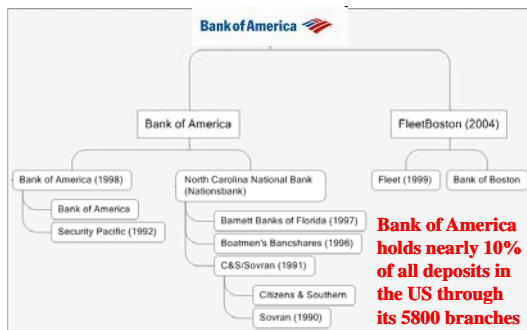
The global OEM model is not just for Nike anymore.

Menu has recalled more than 60 million cans of pet food under more than 100 brand names ranging from Procter & Gamble Co.'s Iams and Eukanuba brands to Hill's Pet Nutrition Science Diet, owned by Colgate-Palmolive Co., to Ol' Roy pet food by Wal-Mart Stores Inc. Each was apparently affected by wheat gluten contaminated with melamine, a chemical substance with no approved use in food.

Q: If household savings have moved to mutual funds, what happened to the banks?

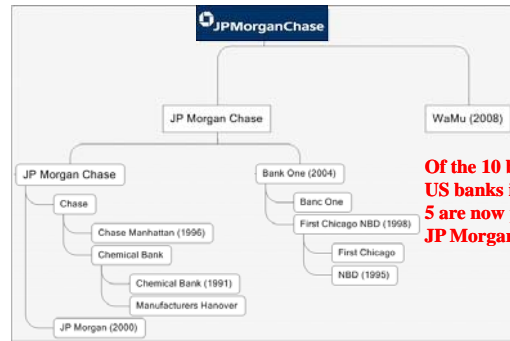
A: They got acquired by Bank of America or JP Morgan Chase

How North Carolina National Bank became Bank of America



Bank of America holds nearly 10% of all deposits in the US through its 5800 branches

How (almost) every New York-based commercial bank became JP Morgan Chase



Of the 10 biggest US banks in 1989, 5 are now part of JP Morgan Chase

Q: What is the date of this article?

The New York Times nytimes.com

Dingell's Sweeping Claims About Citicorp's Solvency

By MICHAEL QUINT

In a sweeping accusation that was quickly repudiated by a top banking regulator, Representative John D. Dingell asserted yesterday that Citicorp was "technically insolvent" and "struggling to survive."

The claims by Representative Dingell, Democrat of Michigan, were made at a hearing of the House Energy and Commerce Committee's Subcommittee on Telecommunication and Finance about granting banks authority to enter new businesses.

Mr. Dingell, who opposes the expansion of bank powers in the securities and insurance businesses, noted that Citicorp had lost money from its effort to expand in overseas securities markets and claimed that those losses had put the company in dire straits. He later asked Treasury Secretary Nicholas F. Brady, who was testifying at the hearing, whether Citicorp had been borrowing heavily from the Federal Reserve. Seidman's View

The surprising new geography of banking

Ten largest US-based traditional commercial banks

Bank	Location
JP Morgan Chase	New York
Bank of America	Charlotte, NC
Citibank	New York
Wells Fargo	San Francisco
State Street	Boston
PNC/National City	Pittsburgh
US Bank	Minneapolis
Bank of NY/Mellon	New York
Suntrust	Atlanta
Regions Bank	Birmingham, AL

7 of the 10 largest US cities no longer have a major local commercial bank.

The basic business of banking has changed



"No, but you . . . you . . . you're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house . . . right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others. Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can. Now what are you going to do? Foreclose on them?"

Banking 2.0: This time, it's impersonal



"No, but you . . . you . . . you're thinking of this place all wrong. As if I held your mortgage on my balance sheet. I sold your mortgage to Countrywide 10 minutes after we closed the deal, and they sold it along with 3000 other mortgages to Merrill Lynch, which divided it into bonds that were bought by a Cayman Islands LLC, which bundled them together with other mortgage-backed bonds into a collateralized debt obligation that Citigroup sold to a Norwegian pension fund. Now what are you going to do? Stop making your payments and force those Norwegian retirees to go back to work?"

Securitization: or, What can be bundled together and sold as bonds?

- Mortgages
- Auto loans
- Student loans
- Corporate loans
- Credit card receivables
- Business receivables (even in distress)
- Settlements of tobacco lawsuits
- David Bowie's royalties
- Blends of the above (CDOs)
- Your neighbors' life insurance policies

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Whether term or whole life, you could get cash for your life insurance policy. Don't leave money in a sock drawer - **85% of all life insurance policies never pay a death benefit** and life settlements provide 300% of the cash surrender value on average. Many people don't realize that there are options to giving up a policy or getting only the cash surrender value.

Thanks to securitization, a US bank today is often a façade—a portal to financial markets

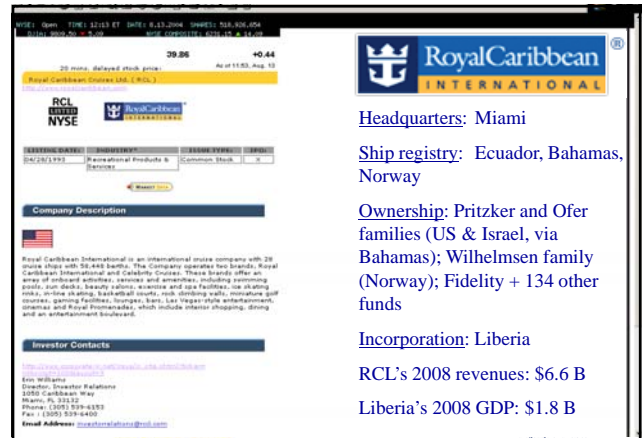


What's a government to do?

"The interests of a transnational company are not the same as those of the country from which it originates or of the workers it has historically employed. It has become, to coin a phrase, a 'rootless cosmopolitan.'"

Martin Wolf, *Why Globalization Works*

If you can't beat 'em, join 'em:
Governments as vendors in a marketplace of laws



NYSE: RCL 39.26 +0.44
20 min. delayed stock price. As of 11:53, Aug. 13
Royal Caribbean Group Ltd. (RCL)

Company Description

Royal Caribbean International is an international cruise company with 28 cruise ships with 50,000 berths. The Company operates two brands, Royal Caribbean International and Celebrity Cruises. These brands offer an array of onboard amenities, services and amenities including swimming pools, sun decks, beauty salons, spas and saunas, ice skating rinks, trivia on deck, basketball courts, rock climbing walls, miniature golf courses, gaming facilities, lounges, bars, Las Vegas style entertainment, spas and Royal Promenade, which include shops, shopping, dining and an entertainment boulevard.

Investor Contacts

1-800-828-6862
Eva Williams
Director, Investor Relations
3100 Caribbean Way
Miami, FL 33132
Phone: (305) 359-6193
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Headquarters: Miami

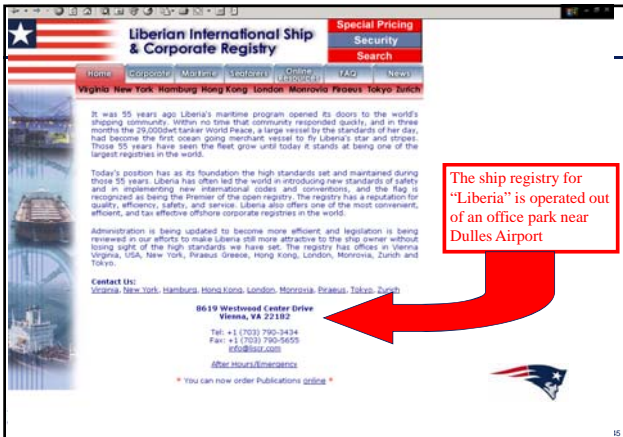
Ship registry: Ecuador, Bahamas, Norway

Ownership: Pritzker and Ofer families (US & Israel, via Bahamas); Wilhelmsen family (Norway); Fidelity + 134 other funds

Incorporation: Liberia

RCL's 2008 revenues: \$6.6 B

Liberia's 2008 GDP: \$1.8 B



Liberian International Ship & Corporate Registry

Home Corporate Maritime Maritime Online (LIVINGSHIP) (IAC) News

Virginia New York Hamburg Hong Kong London Monrovia Provas Tokyo Zurich

It was 55 years ago Liberia's maritime program opened its doors to the world's shipping community. Within no time that community responded quickly, and in three months the 29,000-ton tanker World Peace, a large vessel by the standards of her day, had become the first ocean going merchant vessel to fly Liberia's star and stripes. Those 55 years have seen the fleet grow until today it stands at being one of the largest registries in the world.

Today's position has as its foundation the high standards set and maintained during those 55 years. Liberia has often led the world in introducing new standards of safety and in implementing new international codes and conventions, and the flag is recognized as being the Premier of the open registry. The registry has a reputation for quality, efficiency, safety, and service. Liberia also offers one of the most convenient, efficient, and tax effective offshore corporate registries in the world.

Administration is being updated to become more efficient and legislation is being reviewed in our efforts to make Liberia still more attractive to the ship owner without losing sight of the high standards we have set. The registry has offices in Vienna, Virginia, USA, New York, Piraeus, Greece, Hong Kong, London, Monrovia, Zurich and Tokyo.

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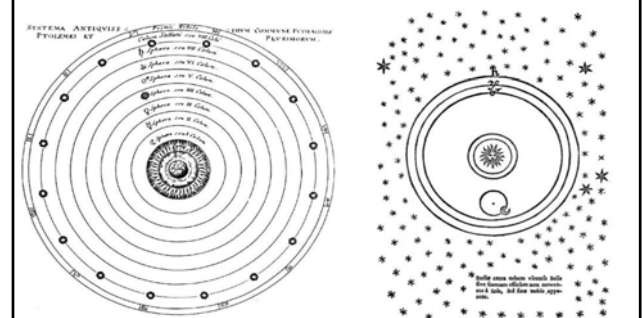
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The ship registry for "Liberia" is operated out of an office park near Dulles Airport

Conclusion: a Copernican shift in American society



SYSTEMA ANTIQVVM PTOLEMAEI
Ptolemy's geocentric model showing Earth at the center with concentric circles for the Moon, Sun, and planets.

SYSTEMA COPERNICVM
Copernicus's heliocentric model showing the Sun at the center with planets orbiting it.

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