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Where Markets Fail: Markets Are Not Systemic

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Markets are usually not systemic. Instead, from the bird's-eye perspective of "Capitalism," many businesses are "opportunities" in the same way that it feels good to hit yourself in the head with a hammer: It's much better once you stop.

For example, the rising sea levels induced by climate change necessitate the construction of seawalls to prevent flooding. From the market standpoint, investors in the seawall-building company will benefit. Yet, at the systemic level, for capitalism as a whole, this is a capital loss. Why? There are new seawalls, but had sea levels been static, the capital contained in the bricks, mortar, and labor could have been deployed elsewhere for a positive return.

Instead, what looks like return at the market level is actually symptomatic of stranded and wasted capital.

Perhaps the sea level example is too prospective for you. What about how the cost of treating lung cancer is a "win" for investors in health-care companies? Tobacco companies generate returns on the front end. Labor (capital "L") also benefits because, as the supply of productive workers drops and the demand for workers holds steady, net wages go up. Yet, in a systemic context, the costs of dealing with cigarette smoking are disastrous.

So here we have two companies and an entire capitalistic entity, Labor, that enjoy returns on capital and yet, for the system as a whole, their activities actually destroy capital.

I am not blaming tobacco companies, health-care firms, or even cigarette smokers. I am just pointing out that markets log returns on capital, when, in fact, what is actually happening at the systemic level is capital destruction. As capitalists, we must treat capital as precious.

As a cynical investor, these scenarios can result in a great pairs trade, right? But this is a failure of markets that could and should be corrected by investors. The question is how.

Possible Remedies

- Recognize that under capitalism one dollar equals one vote. Vote for businesses that generate returns on capital at the systemic level.
- Examine your portfolios for companies that destroy capital at the systemic level. If you do not sell them, have a conversation with a non-financial professional whom you love — say a spouse, parent, or child — and explain why you are invested in that particular "asset."
- As you conduct your analyses, place the investment in a context wider than just an "industry" or "market." Are the company's activities truly economic? Are hidden externalities or liabilities not priced on the balance sheet and consequently not properly expensed, raising the profit level too high? Put another way, are you accounting for all of the capital used by a business?
- Recognize that as active managers we have been seduced by the flawed logic that investing in secondary markets is a zero-sum game. This is rubbish. The value accretion to secondary market prices is, in the long-run, equivalent to the economic value added/returns on capital.

In the next and last entry in this series, I will explore how "Markets Have 'Visible Hands'."

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