The Position of the Individual Investor

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One of the most common statements heard today in the investment business is "The individual investor is out of the market today because he doesn't stand a chance with the big institutions controlling the market." It is time to take a close look at this concept to see if there is truth in it and also to consider the relative advantage or disadvantage the individual has as opposed to the large institution.

There is no doubt that individual investors account for a smaller percentage of stock transactions today than they did 20 years ago. In fact in terms of either share volume or dollar volume they have gone from about two-thirds of the market to about one-third. Volume is much higher now so the above change is partly due to the growth of institutions and only partly due to the disappearance of individuals. Whether individuals have moved out of the market because of institutional dominance or whether institutional dominance has occurred because individuals have moved out is not certain.

Before going on it is necessary to define what is meant by institutions or rather what is not meant by institutions. Institutions are the pension and profit sharing trusts, mutual funds, insurance companies, bank trusts, and other large trusts, they are not the professional traders who invest their own funds as a full time job and may be specialists or market makers. This latter group must be considered separately and if they do better or understand the market better it is because they spend the time, exert the effort, and have the skills necessary for success. It should also be emphasized that the belief that institutions have "inside information" or "control the market" is generally wrong. Using inside information is illegal and institutions are less likely to expose themselves in that fashion than are individuals. Institutions may get better information but they rarely get or act on inside information as the term "inside information" is generally used. Institutions may dominate the market or noticeably impact the market but they are rarely in a position to control the market and domination is more of a disadvantage than an advantage in most cases. To get a better feeling for the relative positions of the individual and the institutions we will look at the important ingredients of investment success one at a time.

Information

Access to information and advice is an important requirement for successful investing. In this area the institutions have an advantage, not so much because they can get information that is not available to the individual, but because they have more funds with which to purchase information and more time to evaluate and analyze it. At some point however more and more information and analysis becomes so conflicting as to be confusing and different portfolio managers within the same institution often have different opinions. The individual investor has access to a considerable amount of information already evaluated but he must spend at least enough time to choose the sources he will use. On balance the instituions have an advantage over the individual in obtaining information.

Costs

Transaction costs can impact the rate of return in an investment program and sometimes quite significantly. The individual, whether he deals with a full service or discount broker, will pay higher commissions than an institution. The difference can be significant if there is frequent trading and with once a year turnover the additional cost can run 1% a year. Commissions, however, are only one aspect of transaction costs and the impact of order size on execution price can be just as significant. If a stock which is moderately liquid is quoted 30 to 30¼, the individual investor can probably buy up to 500 shares at 30¼ and, if when it is time to sell the stock is at the same price, sell at 30 for a transaction cost of ¼ (plus commissions). On the other hand an institution buying 20,000 shares may have to pay an average of 30½ and sell at 29¾ for a transaction cost of ¾ (plus commissions), because the size of the order effects the price. In the example the total transaction cost for the institution would be higher even if they paid only 8¢ a share commission. While it is true that this additional cost to the institution can be avoided by fourth market transactions (institutions dealing with other institutions), by the matching of trades by the broker, or by the broker taking a position in order to keep the spread narrow; brokerage firms are less willing to take risk positions at the lower commissions they get now as opposed to their institutional commissions when commission rates were fixed. Some research suggests that total transaction costs are higher for institutions now than they were when they paid full commissions because they must pay more for their stock. There is not sufficient evidence to support this contention, but it does appear that in terms of total transaction costs the institutions have only a slight edge over the individual investor.

Flexibility

Flexibility, the capacity to choose the investments deemed best and to change quickly, is one of the most significant requirements for investment success. It is in the area of flexibility that the individual investor has a tremendous advantage over the institution. An institution's approach to the market is severely limited by law, by advisory agreements, by their large size and by professional custom.

Institutions are limited as to what kinds of investment areas they may participate in as well as the specific investments within a category. Most cannot invest in commodities, cannot invest in small companies, can only use options in a limited way, cannot short the market, cannot use margin, cannot put significant amounts of their assets into any one company, can only invest in certain types of real estate operations, find it difficult to buy and sell securities that are not highly liquid, — the list of restrictions goes on. In addition to imposed restrictions most institutions limit themselves further in their prospectuses or bylaws and are particulary restrained from taking effective action in bear markets.

Institutions are also limited in their ability to change their investment direction quickly. Their size makes it difficult to change their portfolio without effecting the market adversely. Mutual funds are limited by the tax code from having too many short term trades. Pension trusts are restricted from aggressive action by the fear of criticism or lawsuit and the provisions of the Pension Reform Act tend to make trustees even more conservative in the restrictions they place on their investment advisors.

Even if institutions were allowed to be and wanted to be more flexible, their size prevents them from investing in a large proportion of the securities available to the individual investor. In a market such as the one in recent years where the OTC and lesser known listed stocks have outperformed the blue chips the institutions have suffered.

Objectives

Specific objectives are essential to successful investment strategies. While institutions may have defined objectives these objectives are at best an averaging of the perceived objectives of those who have their assets in the institution. While the specific risk/reward profile of an investment must be related to the situation of the investor, the institution must guess at the needs and desires of its assetholders. The problem is further complicated by the fact that risk as defined and acted on by courts and legislative bodies is largely superstition and only slightly related to analytical measures of risk. As a fiduciary, however, the institution is bound by legal definitions even when they are absurd.

The individual investor has a distinct advantage over the institution in terms of flexibility. They can move more quickly, have a wider range of opportunities and can tailor their program more effectively. They have only themselves to answer to.

On balance it appears that the individual investor is at least as well off as the institution and probably has an advantage. Some people feel there is a further advantage in that the individual investor can follow the institutions' moves and take advantage of them by watching their direction and their involvement in various securities. We are somewhat doubtful of this strategy but then we are somewhat doubtful about technical analysis in general, but that is a personal predjudice.

While our basic feeling is that the individual has an advantage over the institution we cannot end our observations without saying that the individual investor's advantages are potential advantages. The individual has freedom of action but freedom is only an opportunity. Many individuals use their freedom to engage in investment activities that are not sound and we would not like to venture that individuals do better than institutions, only that they should.