

March 5, 1982

The Honorable John Dingell,  
U. S. House of Representatives,  
Rayburn House Building,  
Washington, D. C. 20515.

Dear Mr. Dingell:

This letter is to comment upon the likely sources for trading activity that will develop in any futures market involving stock indices. My background for this commentary is some thirty years of practice in various aspects of the investment business, including several years as a securities salesman. The last twenty-five years have been spent as a financial analyst, and I currently have the sole responsibility for an equity portfolio that totals over \$600 million. I am enclosing copies of several articles that relate to my experience in the investment field.

It is impossible to predict precisely what will develop in investment or speculative markets, and you should be wary of any who claim precision. I think the following represents a reasonable expectancy:

1. A role can be performed by the stock index future contract in aiding the risk-reducing efforts of the true investor. An investor may quite logically conclude that he can identify undervalued securities, but also conclude that he has no ability whatsoever to predict the short-term movements of the stock market. This is the view I maintain in my own efforts in investment management. Such an investor may wish to "zero out" market fluctuations and the continual shorting of a representative index offers him the chance to do just that. Presumably an investor with \$10 million of undervalued equities and a constant short position of \$10 million in the index will achieve the net rewards or penalties attributable solely to his skill in selection of specific securities, and have no worries that these results will be swamped - or even influenced - by the fluctuations of the general market. Because there are costs involved - and because most investors believe that, over the long term, stock prices in general will advance - I think there are relatively few investment professionals who will operate in such a constantly hedged manner. But I also believe that it is a rational way to behave and that a few professionals, who wish always to be "market neutral" in their attitude and behavior, will do so.

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2. As previously stated, I see a logical risk-reducing strategy that involves shorting the futures contract. I see no corresponding investment or hedging strategy whatsoever on the long side. By definition, therefore, a very maximum of 50% of the futures transactions can be entered into with the expectancy of risk reduction and not less than 50% (the long side) must act in a risk-accentuating or gambling manner.

3. The actual balance would be enormously different than this maximum 50/50 division between risk reducers and risk accentuators. The propensity to gamble is always increased by a large prize versus a small entry fee, no matter how poor the true odds may be. That's why Las Vegas casinos advertise big jackpots and why state lotteries headline big prizes. In securities, the unintelligent are seduced by the same approach in various ways, including: (a) "penny stocks", which are "manufactured" by promoters precisely because they snare the gullible - creating dreams of enormous payoffs but with an actual group result of disaster, and (b) low margin requirements through which financial experience attributable to a large investment is achieved by committing a relatively small stake.

4. We have had many earlier experiences in our history in which the high total commitment/low down payment phenomenon has led to trouble. The most familiar, of course, is the stock market boom in the late 20s that was accompanied and accentuated by 10% margins. Saner heads subsequently decided that there was nothing pro-social about such thin-margined speculation and that, rather than aiding capital markets, in the long run it hurt them. Accordingly, margin regulations were introduced and made a permanent part of the investing scene. The ability to speculate in stock indices with 10% down payments, of course, is simply a way around the margin requirements and will be immediately perceived as such by gamblers throughout the country.

Brokers, of course, favor new trading vehicles. Their enthusiasm tends to be in direct proportion to the amount of activity they expect. And the more the activity, the greater the cost to the public and the greater the amount of money that will be left behind by them to be spread among the brokerage industry. As each contract dies, the only business involved is that the loser pays the winner. Since the casino (the futures market and its supporting cast of brokers) gets paid a toll each time one of these transactions takes place, you can be sure that it will have a great interest in providing very large numbers of losers and winners. But it must be remembered that, for the players, it is the most clear sort of a "negative sum game". Losses and gains cancel out before expenses; after expenses the net loss is substantial. In fact, unless such losses are quite substantial, the casino will

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terminate operations since the players' net losses comprise the casino's sole source of revenue. This "negative sum" aspect is in direct contrast to common stock investment generally, which has been a very substantial "positive sum game" over the years simply because the underlying companies, on balance, have earned substantial sums of money that eventually benefits their owners, the stockholders.

6. In my judgment, a very high percentage - probably at least 95% and more likely much higher - of the activity generated by these contracts will be strictly gambling in nature. You will have people wagering as to the short-term movements of the stock market and able to make fairly large wagers with fairly small sums. They will be encouraged to do so by brokers who will see rapid turnover of customers' capital - the best thing that can happen to a broker in terms of his immediate income. A great deal of money will be left behind by these 95% as the casino takes its bite from each transaction.

7. In the long run, gambling-dominated activities that are identified with traditional capital markets, and that leave a very high percentage of those exposed to the activity burned, are not going to be good for capital markets. Even though people participating in such gambling activity are not investors and what they are buying really are not stocks, they still will feel that they have had a bad experience with the stock market. And after having been exposed to the worst face of capital markets, they understandably may, in the future, take a dim view of capital markets generally. Certainly that has been the experience after previous waves of speculation. You might ask if the brokerage industry is not wise enough to look after its own long-term interests. History shows them to be myopic (witness the late 1960s); they often have been happiest when behavior was at its silliest. And many brokers are far more concerned with how much they gross this month than whether their clients - or, for that matter, the securities industry - prosper in the long run.

We do not need more people gambling in non-essential instruments identified with the stock market in this country, nor brokers who encourage them to do so. What we need are investors and advisors who look at the long-term prospects for an enterprise and invest accordingly. We need the intelligent commitment of investment capital, not leveraged market wagers. The propensity to operate in the intelligent, pro-social sector of capital markets is deterred, not enhanced, by an active and exciting casino operating in somewhat the same arena, utilizing somewhat similar language and serviced by the same work force.

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In addition, low-margined activity in stock-equivalents is inconsistent with expressed public policy as embodied in margin requirements. Although index futures have slight benefits to the investment professional wishing to "hedge out" the market, the net effect of high-volume futures markets in stocks indices is likely to be overwhelmingly detrimental to the security-buying public and, therefore, in the long run to capital markets generally.

Sincerely,

Warren E. Buffett

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