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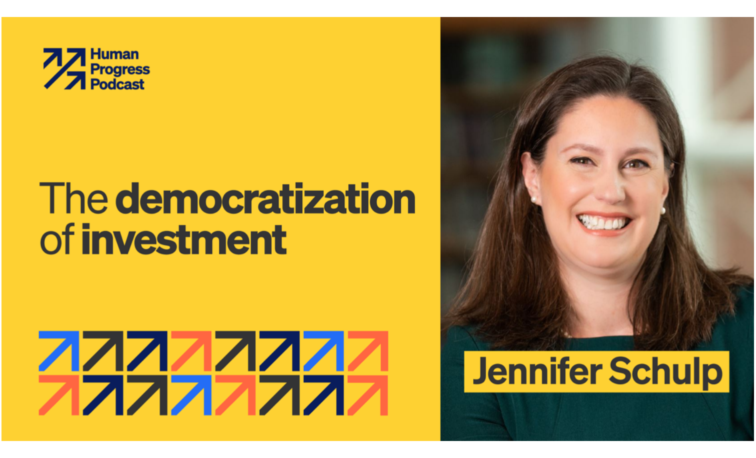

The Human Progress Podcast | Financial Market Development

The Democratization of Investment

On the one hand, investing has never been easier. Anyone with a smartphone and a bank account can now trade stocks, allowing increasing numbers of people to access the wealth machine.

On the other hand, financial regulations have become more restrictive, and governments are increasingly manipulating financial markets to advance ideological goals.

In this episode of The Human Progress Podcast, Jennifer Schulp, the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives, joins Chelsea Follett to discuss how technology and politics are shaping the future of investment.

Listen to the interview

Below is an edited and abridged transcript featuring some highlights from the interview.

Tell me about some hopeful trends or progress we are seeing in the financial industry.

One of the most hopeful trends in the financial industry is broader access to financial investment. Traditionally, investment in the stock market has been limited to the wealthy. Investing in the stock market is really important because, over the past decades, the S&P 500 has returned approximately 8 percent per year, which is way more than other non-equity investments.

Financial access has improved tremendously over the last 50 years. In the mid-70s, to make a stock trade, you had to call your broker on the phone and tell them what you wanted to trade, and they would charge you something like $50. So, you didn't want to place a trade unless you were placing a large trade because otherwise, the fee would overwhelm the trade. And you didn't want to trade very often. All of it made it very difficult for regular people to invest in the stock market. Over the course of decades, those fees came down as there was additional competition brought into the brokerage space.

In the 1990s, we saw the rise of internet trading, which allowed you to place trades on your own. In 2015, Robinhood started offering no-commission trading on a phone app, which allows people to trade regularly without worrying about fees eating into their profits or adding to their losses. People can now take some money from each paycheck and put it in the stock market. That's been huge. The entire brokerage industry is now moving towards phone access for easy, cheap trading, and that's made a huge difference in the number and type of people accessing investment in the stock market.

In 2020, during the pandemic, we saw a massive rise in retail trading that many wrote off to people being bored while they were stuck in their homes. However, a lot of those investors have remained in the market, so what might have started as a pandemic-induced interest in the stock market has become part of a long-term trend towards additional retail trading that has brought in more racial minorities, more low-income people, and more young people.

Easy and cheap trading has also allowed people to experiment with the stock market and learn by doing. There was a study that came out not too long ago by FINRA and NORC at the University of Chicago that looked at the investors who opened accounts in 2020. And they found that those who stayed in the market showed an increase in their financial literacy. Having this access helped them allocate their capital better. So, we have more people invested in the larger economy, and they are getting smarter about it. The benefits will compound over time.

What are some of those potential benefits?

Certainly better personal financial outcomes. Of course, some people are going to make poor decisions. You can't say, "Because you put money in the market, you'll be better off." But for people looking for long-term investment options, the stock market is the greatest wealth generator we've ever seen.

I think this could also drive economic growth for a couple of reasons. One, investment gives people a stake in society and the economy, and that itself can drive growth. Two, having retail investors put money that might otherwise be under the mattress or in a low-interest savings account into businesses allows those businesses to flourish.

Are there any benefits for those who are trying to start businesses?

That brings up a new set of questions. What we've been talking about so far has been retail investment in public equities markets. But the stock market doesn't generally provide startup capital. You have to be a mature company to want to bring an initial public offering that gets you listed on the stock exchange. Private market investing is where startup investing happens. And in the United States, far more money is raised in private markets than in public markets. The average person is not allowed to partake in private investment in the United States, as well as in most economies across the world. In the US, you need to be what's known as an accredited investor, which essentially means you make more than $200,000 a year or you have a net worth of over a million dollars.

This is a very arbitrary standard. You could win the lottery tomorrow and suddenly become an accredited investor, and that doesn't make you any smarter at investing than you were the day before. It doesn't make you any more of a capable investor than someone who, say, studied startup investing in their MBA program but isn't yet making enough money to be allowed to invest themselves. And all of this is a problem because it means the government is standing in the investor's shoes and making decisions for them. Are they smart enough? Are they rich enough? Is this a good idea for them?

Let's talk about entrepreneurs, as you asked. People trying to start businesses tend to turn to their community. They tend to raise money from the people that they know best. But if you are a minority or live in a rural or low-income area, you likely don't know many people who meet that accredited investor standard. You're already at a disadvantage in raising money and getting your business off the ground. That hurts entrepreneurs in less wealthy communities, the economy as a whole, and potential investors who don't have the opportunity to share in the growth of that business.

The house recently passed three bills looking to reform the accredited investor definition; two have codified an SEC modification to the rule allowing people who have passed certain securities tests, such as brokers or investment advisors, to qualify as accredited investors, even if they're not wealthy enough. The third bill is a bit broader; it opens up the testing concept to allow, if passed by the Senate and signed by the President, anyone who passes a test to be able to invest as an accredited investor. There will be costs associated with the testing, and it doesn't get at the underlying paternalism, but it is a step in the right direction.

Could you talk about ESG?

ESG is actually two distinct concepts, and it's important to identify which one we're talking about. It can be broken down into a dichotomy that I've borrowed, which is value versus values investing.

"Value investing" in the form of ESG just refers to using environmental, social, or governance factors to analyze whether a company faces risks that might affect its financial performance. Where ESG sounds a little bit different is when we think about it as "values investing." That kind of ESG is about sacrificing financial return to reach a certain outcome with your investment, like lowering carbon emissions. Of course, investors should be free to invest their money as they see fit. If they want to invest in saving the whales, they should have that opportunity. But it gets trickier when a company or asset management firm makes those decisions about what to do with their investors' money without being upfront with them. That's a question of disclosure and whether or not the funds are being clear with investors.

Government mandates are the key place to focus on here because, ultimately, the market should decide whether investing in ESG is the right way to go. Europe has decided, writ large, that the way to tackle climate change is to centrally plan how money will flow through the financial system to choke off funds for non-green investment. Supporting that is a host of European directives on sustainable finance that include a lot of disclosure by companies about how they, too, will meet net-zero goals. Europe has what we in the securities industry refer to as a "double materiality standard," where European companies are not only supposed to disclose information that might impact the company's financial performance but also how their company impacts society and the environment. All of this comes with pretty heavy costs.

The United States is now considering how far to follow Europe down that line. The Securities and Exchange Commission (SEC) has proposed a sweeping climate risk disclosure framework. It's different from the European framework in that the SEC at least recognizes that they don't get double materiality; the SEC is only allowed to require companies to disclose information that investors might find useful in deciding whether to invest in the company. However, the SEC's climate risk disclosure rule goes well beyond that. It would require all US public companies to disclose an awful lot of information about climate risk, including scope one, scope two, and, for many companies, scope three, greenhouse gas emissions. What's important here is that this type of disclosure is not a small undertaking. The SEC itself, which most certainly underestimated the costs of this policy, admits that it would triple the cost of public company disclosure. It's going to be a massive drag on public companies.

You also oppose government rules that would restrict voluntary ESG-related disclosures. Can you tell me about that?

Sure. There's been some legislation introduced, some of it passed, from state-level Republican legislatures that prohibits the use of ESG in investment. But this broad prohibition is also not the right answer. In fact, it is itself values-based and seeks to impose an ideology onto investing.
In addition, there are real costs to blanket prohibitions of ESG. One is that ESG as value investing can sometimes yield better returns. Pensions in some states that have introduced legislation to prohibit the consideration of ESG factors have released analyses showing that over the course of 10 years, the pensions might be losing billions of dollars in returns by having their investment pool artificially limited.

Another example is Texas, which prohibits localities from doing business with financial firms that are, quote, "boycotting the fossil fuel industry." A study done not too long ago showed that the cost of municipal borrowing has gone up in Texas because many firms exited the market, meaning taxpayers in Texas are now paying more for municipal building projects. We shouldn't forget that narrowing the scope of investment opportunities also narrows the opportunities for growth.

Could you speak about the potential impact of AI on investment and the financial industry?

Many people don't understand how much AI is already part of the investment industry. For example, AI is already involved with investment research, predicting stock value, and portfolio management. That's all going on behind the scenes.

I think that there's real potential with respect to financial advice. AI could make investment advice as accessible as trading on your phone is today. For a long time, we've had what are known as robo-advisors, which are essentially chatbots with a narrow tree of advice based on a set of questions. More sophisticated large language models could give individualized investment advice that considers all sorts of circumstances at a very low cost. In the future, you may be able to go on your computer or phone and tell the LLM, here's what my investments look like; what should I do next? That's powerful stuff, assuming that the regulators allow something like that to happen.

Read the full transcript