Prosperity, the US and us

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The first year of the third millennium opened with a question likely to dominate investment thinking for the foreseeable future – is the giant US economy, on which we all so greatly depend, slipping into recession?

Early in the year, US Federal Reserve chairman Dr Alan Greenspan chilled confidence in the US with his pronouncement that the country's economic growth had slowed substantially, "probably close to zero".

Concerns mounted in the US about employment prospects, income and business conditions. Commentators warned, however, of the dangers of turning what could well be an eminently manageable slowdown into a real recession through self-fulfilling gloom. The Federal Reserve moved quickly to stem the rising gloom by cutting interest rates twice in less than a month.

Other central banks, including Australia's Reserve Bank, chimed in, warning anyone who needed a reminder of the significance of the US's economic health for global wellbeing and exporting nations generally. With the US representing between one-fifth and one quarter of the world's gross domestic product, its performance is of key interest to the rest of the world.

And the world has indeed been watching the US's remarkable 10-year sharemarket and economic boom with fascination, excitement and, most recently, considerable apprehension. Because all booms must end – the burning issue is when and how, whether by fizzling out or crashing into a bust.

Along the way, as has occurred also in Australia over the past decade, many average citizens have boosted the number of shareholders and, being holders of shares which appeared to be inexorably increasing in value, felt correspondingly wealthier. This happy state of mind – the "wealth effect" of a sharemarket boom – in turn helped fuel consumer spending.

Over the past year or so, however, sharemarket prices have been falling as the heat evaporated out of an overdone boom. This has had a dampening effect on consumer confidence, as those individual shareholders whose sense of affluence was enhanced while they were holding shares which were rising in price were now staring at portfolios of diminishing worth.

So what does this signal for investment markets over the coming twelve months? It would be a brave forecaster who pretended to have a single, definitive answer to this question. But one apparent truism does emerge in such times of tension and change: markets – or those operating in them – are versatile, responsive, innovative and, largely, optimistic. In few other industries can there be as much enthusiasm for turning adversity into advantage, for calling up strategies to head off threats and, it is hoped, learning from experience.

This issue of *JASSA* contains a number of articles which collectively illustrate the diversity of thought behind the evolution of the investment markets. Three in particular focus on elements of strategy and theory in ways that may challenge accepted wisdom. Justin Ryan and Mark Harrison propose a different twist to the process of increasing the value of an enterprise. The popularity of floating companies on the stockmarket, they say, should not overshadow the benefits of the reverse – privatising public companies. The authors remind investors about the abundance of capital available in the private-equity sector.

Martin Gold looks at index funds and explains the seemingly paradoxical feature that they have no intrinsic value: buying an index is merely buying a measure of the market. Without dwelling on the active/passive style debate, Gold concludes that an index approach might not suit the objectives of many investors.

Chris Heyde, Shuangzhe Liu and Roger Gay continue a long-running discussion about option pricing and offer an extension of existing portfolio theory. Their new model introduces a change to the Black-Scholes stock price which enables "straightforward pricing of options, bypassing advanced numerical techniques". The authors' inclusion of a 100-year-old reference is a subtle reminder of the enduring nature of this debate.

Appropriately, this issue of *JASSA* also commemorates the Securities Institute's 35th anniversary with a retrospective covering its progress from a pioneer in education with a tiny staff to a large organisation whose influence extends nationally across Australia and extensively overseas.