Sunday, 18 April 2021

A Piece of the Action

The Drop - *September 1958*

- Within the culture of banking, it was corporations that mattered, not consumers. Making loans to large companies was the most prestigious activity in all of banking; making customer loans, on the other hand, was considered slightly disreputable, and such loans were ceded to finance companies, which were also considered slightly disreputable
- Bank of America was different. It was a bank with the mentality of a finance company and proud of it. It eagerly embraced the customers other banks disdained, and in that embrace it found enormous success. The bank had been founded in 1904 by the legendary A. P. Giannini, the son of an Italian immigrant who had settled in San Jose, California, forty-five miles south of San Francisco. Long after the bank had delved into other businesses, like corporate lending, Giannini never forgot that it had been built by attracting deposits from, and lending money to, “the little fellow,” as he called his customers. He never let anyone else forget it either. He was full of aphorisms promoting the essential goodness of the common man and the wisdom of lending to him. “The little fellow is the best customer that a bank can have, because he is with you,” Giannini once told a congressional committee. “Whereas the big fellow is only with you so long as he can get something out of you; and when he cannot, he is not for you anymore”
- Well into the 1950s and beyond, the Depression remained the nation’s dominant economic memory. It had been such a searing experience that people who lived through it adopted a set of financial habits and attitudes that would last long after the event itself had receded into the country’s subconscious. The ethos of thrift was one natural result of the Depression experience. So was an aversion to financial risk. That’s why so few people even thought about the stock market and why the vast majority of Americans were content to keep their money in bank passbook accounts
- Williams also had to solve a peculiar paradox, one that would crop up again and again in those early years. It’s another one of those things we have tended to forget as credit cards have become commonplace: A successful credit card program requires the participation of not just customers but store owners as well. In fact, it requires thousands of store owners, who have to be recruited with the promise that there will be enough cardholders to make accepting the card - and handling 6 percent of the purchase price to a bank - worth their while. At the same time the bank is recruiting merchants, though, it must also recruit

cardholders - promising them that there will be enough merchants signed up to make carrying the card worth their while. It was a chicken-and-egg dilemma. Which came first, the customers or the merchants? The “drop” was William’s solution to this problem. Rather than recruit cardholders, he decided to create them. He would mail cards to anyone who did business with Bank of America, free of charge. He fully expected them to view the arrival of the card as a wonderful new service the bank was providing. If they didn’t see it that way, Williams assured that they would just toss it away

- What had gone wrong? It’s hard, in hindsight, to think of anything that didn’t go wrong. The bank’s frantic effort to push credit cards out the door had degenerated into a small catastrophe. Delinquent accounts? They weren’t 4 percent as Williams had predicted; they were 22 percent. Collections? Williams, convinced the BankAmericard program would never have to worry about collecting on its loans, hadn’t even bothered to set up a collections department. Fraud? It was rampant. Resistance to the bank? It was everywhere, especially among the larger merchants, who hated the idea of paying 6 percent to the Bank of America, and resented its attempt to get into the credit card business. Bank of America salesmen got nowhere with them. As a result, those early merchants were dominated by “the league of pawn shops, taverns and bail bond houses,” as one writer would later describe it

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The Man with the Golden Touch - *February 1966*

- “Bringing Wall Street to Main Street” was the way Merrill liked to describe his life’s work, and although his life ended well before his work was done, those woulds would echo through the decades, as events gradually conspired to push Americans in the direction Merrill had always tried to lead them. In time, his central idea, that the middle class should be investors as well as savers, would be at the heart of the money revolution
- The stock and bond markets were completely and unapologetically an insider’s game in the early part of this century; the ultimate insider was J. P. Morgan. The markets were run by Morgan and other wealthy insiders for their own benefit, and woe to anyone who tried to interfere. Small investors were not just scorned; their business was often turned away even when it arrived over the transom
- And on March 31, 1928, he was the first to tell his clients to get out of the stock market. This was another of those stories Merrill would recount for the rest of his life, but this was no exaggeration: He saw the great crash coming, and he said so. He saw it, in fact, nineteen months before it happened, at a time when stock prices were still rocketing upward and when the small investors Merrill wanted in the market were finally racing in. But they were doing so in the wrong way and for the wrong reasons - piling up margin debt in a speculative orgy, clamoring to get aboard as the train was leaving the station. Three months later, the market took its first big tumble, but came roaring back. Merrill wangled an appointment to see

Calvin Coolidge, whose presidency was nearing an end, pleaded with the President to help dampen the wild speculation, even offered him a partnership in the firm after he left the White House - with his only task being to speak out publicly against speculation and margin debt. Coolidge was unmoved. By February 1929, as the market was making its last wild climb, Merrill was liquidating much of his firm's stock portfolio

- Putting his brokers on salary was Merrill's way of eliminating the temptation. A salaried broker, he believed, would be better able to guide clients to long-term investments without having to worry about the need to generate periodic trades. And the customer, listening to his broker's advice, would know that it wasn't motivated by the prospect of commissions. For the rest of his life, Merrill never changed his view about this, and despite periodic grumbling from the brokers, he refused to reintroduce a system of pay based on commissions
- Later, Tsai would complain that "I had one bad year, in 1968, and I've been killed in the press ever since… I don't think it's fair." And perhaps it wasn't. Within a few years, most mutual funds were down as sharply as the Manhattan Fund had once been. One after another, the gunslingers of the era were hanging up their spurs, having been whipped by the market. But Tsai was more famous than all of them put together, and the first to crash to boot; it's hard to see how he could have expected to be treated any differently. He who lives by the press dies by the press. Any movie star could have told him that

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Delusions and the Madness of Bankers - *November 1966*

- Reflecting the essential gentility of the banking world, Larkin recoiled at the prospect of having Bank of America march into other states and sign up merchants and customers itself, even though such a move would have been completely legal. Instead, he came up with the idea of enlisting out-of-state banks as partners instead of enemies. As Larkin envisioned the system, a "licensee" would pay a $25,000 entry fee to Bank of America. In return, the larger bank would turn over the credit card software it had developed, and would show the smaller bank how to run a credit card operation. The smaller bank would then run its own program, mailing its own BankAmericards to people in its own territory, signing up its own merchants, and enlisting its own smaller "licensee" banks to the cause. And, of course, it would reap its own profits or absorb its own losses. Although Bank of America took a small additional royalty, most of that money went to support a national advertising campaign; the licensing program was not intended to be a big money maker for the BofA. Yet every time a new bank was added to the system, Bank of America did wind up making more money, because its own card activity lurched upward. The reason was that there was suddenly a new group of out-of-state merchants ready to accept BankAmericards from anyone, including visiting Californians - and a new group of out-of-state cardholders, ready to use their BankAmericards when they traveled to California. Bank of America's own balance sheet offered all the proof you needed that the more places a credit card could be used, the more people would use it. To be indispensable, a card had to be universal

- Bank of America set up a system whereby the merchant bank would reimburse the store for every credit card sale it made - minus the merchant discount, which it kept for itself. Then the merchant bank would send out the sales drafts to the member banks around the country whose customers had made those purchases. The customers' banks, in turn, would reimburse the merchant bank, taking a fractional amount of the transaction for itself: the interchange fee, this latter amount was called. Finally, the customer's bank would bill the customer for the item. When the customer paid, the transaction was complete
- Is it surprising to learn that member banks were flouting the rules, cheating each other, entangling themselves in yet another layer of chaos? Perhaps not. The same mind-set that drove bankers to mail credit cards to dogs and infants also drove them to bend the interchange system to their own advantage. Card-issuing banks would receive sales drafts from a merchant bank and then sit on them for weeks at a time, earning interest on money that didn't really belong to them. Or they would unilaterally refuse to accept certain sales drafts from a merchant bank, claiming they were invalid for some preposterous reason. Or the merchant bank would lie about the size of the merchant discount, in order to lower the fee it had to pay to the credit card banks
- Authorization is what makes it possible for a merchant to know that the card being presented to him is valid, and that the cardholder is not exceeding his credit limit. This is another one of those things we scarcely think about, now that it's done electronically. The merchant runs the card through an electronic device, punches in a few numbers, and within seconds he knows whether the purchase is approved. But the electronics didn't exist then, so the merchant had to call the bank, and while he was put on hold, his bank would make a long distance call to the bank that had issued the credit card, and while it was put on hold, the clerk on the other end of the line would pull out a fat printout of names and numbers and look up the customer's balance to see if the purchase could be approved - all while the customer and merchant stood in the store, waiting for the reply. And that was when the system was operating smoothly. Sometimes the merchant got a busy signal. Other times his call went unanswered, something that happened most often when a customer with a card from an East Coast bank tried to buy something late in the day in California. And if he couldn't get through, the merchant then had to decide whether to accept the card or lose the sale. And if he took the card, and it turned out to be stolen, all hell would break loose as the banks fought over who should absorb the loss. There were a hundred problems like that

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The Great Wall of Q - *February 1970*

- "Net redemptions" is the term they use in the mutual fund business when more money flows out of a fund than flows in; by the early 1970s, it was the condition of the industry. The novice investors who had been lured by the hot performance funds were now the most anxious to get their money back in the bank
- Inflation began, almost everyone agrees now, with President Johnson's infamous 1960s guns-and-butter strategy: his decision to finance the Vietnam War and the

Great Society by creating a budget deficit - "printing money," his critics would call it - instead of raising taxes

- As inflation ebbed and flowed, so did interest rates. This is also a phenomenon we've become used to, but it was new then - new and unsettling. In the fall fo 1969, when interest rates on short-term Treasury bills reached 8 percent, it marked a level that hadn't been approached since before the Civil War. There was, however, one interest rate that was *not* ebbing and flowing in lock step with the T-bill. The interest paid to small savers, on the money they kept in bank passbook accounts, was stuck at 4.5 percent, seemingly oblivious to the chaotic events engulfing the rest of the American economy. In 1973, the rate rose, grudgingly, to 5 percent. There it stayed for the next six years - when it rose another quarter of a percent, to 5.25. The interest banks paid to consumers was stuck for a very good reason: that's where the Federal Reserve Bank wanted it to be. Under another one of those Depression-era bank regulations, the Federal Reserve had control over how much interest banks could pay their customers. Its power over bank interest rates was embodied in a rule called Regulation Q, which owed its existence to the Depression-era belief that banks had gotten into trouble in the 1930s because they paid too much interest in competing for deposits. This was quite true in 1933, when Regulation Q took effect; more than 4000 banks closed that year, and the practice of overpaying for deposits had a lot to do with those closings. Forty years later, however, Reg Q had the perverse effect of forcing banks to pay too little interest on their customers' deposits. It had gone from being a rule that protected banks from themselves to being a rule that protected banks from the vagaries of the real world. Banks were actually able to take advantage of inflation and high interest rates - for while Reg Q allowed banks to collect deposits at artificially low rates, they could turn around and lend out that money at the prevailing rate of 10 or 11 percent. Not surprisingly, Q was one regulation bankers did not complain about
- Ultimately, money market funds were the way around Q. It was the most logical response to the disparity between market interest rates and the lower rates forced on the country's saver by the Fed
- Today, there isn't a brokerage house in the country that doesn't stick its customers' cash in money market funds. In those days, however, brokerage firms invested their customers' free credit balances for their own accounts
- If people were willing to move money back and forth between money market funds and banks, it meant that in their own minds, at least, the only difference between the two vehicles was the interest they paid. A blurring had begun between saving and investing, which could only help money funds. A money market fund, no matter how much it looked like a bank account, was still a form of mutual fund - by definition, an investment vehicle. It did not come with federal deposit insurance, the way a bank account did. The possibility - remote though it might be - always existed that some principal might be lost. Yet people were willing to use money market funds the same way they used bank accounts. And the more they used them that way, the more comfortable they became with the idea, and the more blurring took place

- There was one other crucial innovation that helped blur the distinction between a money fund and a bank account. The innovator was the newly installed president of Fidelity Investments, who had been watching the development of the money fund with keen interest. A year and a half after the Reserve Fund gained SEC approval, Ned Johnson introduced Fidelity's first money market fund. It came with a novel twist. You could write checks against it. When Johnson figured out how to add check writing to a money market fund, the blurring was complete
- As word of his fund's prospectus spread, the mutual fund industry was stunned at what Ned Johnson was trying to do. It wasn't so much the technical hurdles that stunned them, but the philosophy that underlay his willingness to allow customers to write checks against their money market fund. In doing so, Johnson was turning his back on one of the industry's most firmly held beliefs. "Make it easy to put money into a fund," went the old mutual fund saw, "but hard to take money out." It often took weeks to redeem mutual fund shares - weeks of paperwork going back and forth in the mail, with silly requirements for notaries and signature guarantees and the like. Though no one ever said it in so many words, the idea was that if you made it hard for people to withdraw from a fund, they wouldn't bother. Check writing turned this idea on its head. With Johnson's fund, it would actually be easier to take money out of a money market fund than to put it in. "Our philosophy was that if you made it easy to withdraw your money, you'd wind up getting more of it," says Johnson now. It sounds like a very basic observation, but it was a powerful new notion at the time. It meant that Johnson had begun to think of Fidelity not as a company that managed funds but as one that sold *products*, the same as any other consumer goods company. Consumer companies succeeded not by resisting the wishes of customers but by embracing those wishes. Customers returned to McDonald's because it made their life easier, not harder. Ned Johnson was going to do that now too. He was going to treat investors like consumers, people whose money he had to fight for, since they had other places to put it - and would soon have many more such places. That's what check writing implied
- With check writing, FDIT didn't just resemble a bank account; it was better than a bank account. Federal Reserve rules required banks to offer passbook accounts that paid interest or checking accounts that didn't. Fidelity was offering check writing and interest in the same account
- Unlike Bent and Brown, or Benham, Ned Johnson did not rely on word of mouth to promote his new fund. Here came the next new wrinkle: he relied on advertising, just like any other consumer-product company
- If you could sell money market funds directly to the public, why couldn't you sell equity mutual funds that way too? Why did you have to continue relying on brokers who were so openly hostile? And why did you even have to impose a load on mutual funds? That money was supposed to be a commission for the brokers, but they had lost interest in selling the product

“Here Come the Revolutionaries” - *July 1970*

- When asked to name the advantages of credit cards, almost no one mentioned one of their biggest advantages - the initial “float” that gave users a month-long, interest-free loan before the bill came due. When asked to name the disadvantages of credit cards, barely 10 percent of those surveyed mentioned the biggest disadvantage: the 18 percent-a-year interest rate, which was much higher than the interest on other kinds of loans. In fact, Mandell noted, “There is some recent evidence that a large proportion of credit card users don’t know the interest that they must pay on their account.” The economist was particularly perplexed by the percentage of the wealthier families who carried a credit card balance. It was only 15 percent, but that seemed awfully high to Mandell, since they clearly had the means to avoid those lofty interest rates. Their behaviour, Mandell concluded, was “irrational”
- In fact, the first organization to propose a central authorization system wasn’t a bank at all; it was American Express. The company had in mind a giant system that would handle not only BankAmericard but Master Charge cards and American Express cards. Although many bankers were amenable to this idea, Hock was not among them. Because American Express issued its own plastic card - its own “medium of exchange” as he tended to think of it - Hock believed that the company was the implacable enemy of the nation’s banks, and he was determined to treat it as such. At one of his first board meetings, Hock stopped the American Express effort cold. We have to control our own destiny, he argued to the board; we can’t be at the mercy of a potential competitor like American Express. Therefore, he said, NBI would build its own system, for the exclusive use of its members

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The Luckiest Entrepreneur - *May 1975*

- The way the discounters went about their business violated too many of the ancient truisms of the brokerage business. “Stocks are sold, not bought” went one such axiom - meaning that most Americans still did not come easily to a decision to buy or sell a stock or bond. They had to be cajoled, prodded, convinced. Brokers activated this process by picking up the phone, planting an idea, slowly reeling in the customer
- At Schwab, however, it was the customer who had to pick up the phone. Employees were supposed to sit at their desks and wait for people to call; then, when people did call, they were under explicit instruction not to offer advice or suggestions. Their job was to write down the caller’s order, and pass it along the Schwab pipeline, whether other employees made the trade and billed the caller. At that point, of course, the caller became a customer, with an “account” at Schwab. Yet even then, no one at Schwab solicited additional business, something a wirehouse would have done as a matter of course. Discounters were operating on a different theory, which grew out of another truism of the brokerage business: “Ten percent of the customers provide 90 percent of the revenues.” It was this 10 percent, the most active investors, that discounters hoped to attract - investors who knew their own minds, and were tired of the incessant phone calls

from their brokers. In one of his first ads, Schwab's slogan was: "Call us because no sales person will every call you"

- The branches did matter after all - they mattered psychologically. It wasn't so much that people would insist on visiting the branch office every time they wanted to make a stock trade, they just needed to know it was there. There was something reassuring about seeing a real office - something that made a financial enterprise seem more solid than when it was represented merely by an ad in the Wall Street Journal. Most of Schwab's new Sacramento customers came into the branch office when they first opened their accounts, but not all of them did. Some of them simply walked by the office. That was enough. Once they had seen it, they were able to pick up the phone and make a stock trade through Schwab. On the East Coast, competing discounters scoffed at Schwab's branch office strategy. "It seemed completely logical to concentrate all my operations in one place," says one of Schwab's former competitors, long since out of business. "What I didn't appreciate until it was too late was that branches made people feel better." That's the insight Schwab had accidentally stumbled upon. *Branches made people feel better*. "They wanted to kick the tires," is how one old Schwab hand describes it

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The World's Most Hated Bank - *August 1977*

- The SRI team concluded that the most important factor driving consumer financial decisions was nothing more than inertia. This may have been the most crucial finding of all. "Limited consumer knowledge about financial matters and social psychology can help explain the inertia," the authors wrote. "The individual feels financial matters are both important and complex. He must resolve the situation, yet he knows his knowledge is insufficient. Comparison shopping only prolongs and accentuates the discomfort. He can best deal with this uncomfortable, dissonant position by ignoring financial issues altogether. Inertia and reliance on friends are psychologically efficient solutions"
- So: people tended to buy life insurance not because they felt an urgent need, but because they happened to bump into their friend the life insurance salesman who talked them into it. They tended to be so wedded to old habits and patterns that they would avoid learning about a new financial product if it meant having to do something differently. They put their money in the bank, opened a non-interest-bearing checking account, took advice from a stockbroker who never picked winners - all for one reason. That's what they had always done. Consumer Financial Decisions did not miss the irony. "The customers, who are not forcing the revolutionary changes now under way, will select the winners"
- People banked wherever it was most convenient. Nothing else mattered - not lower loan rates, not exceptional customer service, not even *bad* service. "You could look at that," says Kahr now, "and say, 'Every fool knows that the key to retail banking is location. So what?' But the 'so what' was that if you were going to create new products and pay lip service to better customer service or better accuracy or timeliness, you had better understand how difficult it's going to be [to show] that those things really have any value in the customer's mind"

- “Duality” refers to the now-common practice of allowing a bank to issue both Visa and MasterCard. In the mid-1970s, however, this practice was very much against the rules, thanks mainly to Hock, who violently opposed duality. Banks could be part of one system or the other, but they couldn’t be part of both. Hock’s rationale was that it was as important for Interbank and NBI to compete with each other as it was for the banks to compete among themselves, and that duality would destroy the competition between the two organizations. The minute banks could join both organizations, he believed (correctly, as events would prove), the two systems would be seen as interchangeable

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The Great Inflation - *July 1979*

- People had responded to the Depression by helping each other out as best they could, but inflation ha the opposite effect on us. It created an ethos as best they could, but inflation had the opposite effect on us. It created an ethos in which people felt justified in cutting special deals for themselves, even when the net effect of those deals was to ratchet up the inflation rate. Whenever a union chief won a demand that his members receive wage increases exceeding the cost of living, his action made inflation worse for all of us, who had to bear the cost of living adjustment to their Social Security payments, they fueled inflation. But when government officials argued that the “spiral of inflation” could only be stopped if Americans were willing to sacrifice for the common good, they got nowhere. Americans weren’t willing to sacrifice for the common good, not when it came to inflation. Inflation didn’t just have a corrosive effect on our money; it had a corrosive effect on us
- Inflation altered forever the relationship of the middle class to its money. Here is when old behaviours were abandoned and new financial habits acquired - habits that would remain with us long after inflation had subsided, just as the habits acquired during the Depression lasted long after that traumatic time had receded into memory. Looking back, it almost seems as though, in some strange, preordained way, everything that had previously taken place in the money revolution had been leading up to this point. Most certainly, everything that happened afterward flowed from it. The Age of Inflation was the money revolution’s ground zero. It marked the moment when everything changed - when the financial life of the middle class would never again be simple or easy
- When price inflation becomes a normal state of affairs, inflationary assumptions weave themselves into every day’s transactions, and the inflationary process becomes so deeply embedded in the economy that it is beyond the reach of policy tinkering by presidential advisers. That’s what economists meant when they talked about the inflationary spiral: workers, anticipating inflation, clamored for higher wages to keep up with the cost of living. Businesses, anticipating wage hikes, raised prices to protect profit margins. Social Security recipients, their monthly checks indexed to the cost of living, began getting larger checks. Which triggered more inflation. Which triggered a new round of wage demands. Which triggered a new round of price increases. The *expectation* of inflation was creating inflation; it was a psychological phenomenon as much as anything else

- Carter did have one new wrinkle. His plan called for federal controls on consumer credit. Essentially, what he was trying to do was rein in credit card debt. Not only was this a new idea, but it was the first new inflation-fighting idea that the inflation czar himself could claim credit for. In talking to a number of iconoclastic economists, Kahn had become persuaded by them that the growth in iconoclastic economists, Kahn had become persuaded by them that the growth in consumer debt, and especially credit card debt, helped propel the inflationary spiral. When Americans borrowed to sustain a lifestyle that inflation was pushing out of reach, went the theory, they were effectively pumping money into the economy. The act of trying to keep pace with inflation was fueling inflation
- What happened next was amazing. People not only didn't find the loopholes, they refused to look for them. The entire country simply stopped borrowing. "No one had ever seen anything like it," recalls Volcker. Kahn made speeches suggesting that people cut up their credit cards, and thousands did so - sending their sliced-up cards to the White House in a show of support for the President's program. It was quickly apparent, however, that cutting up their credit cards was the worst thing they could have done, both for Carter and themselves. For months, consumer borrowing was the only thing that had kept the recession at bay; when the borrowing stopped, the economy collapsed - "within a matter of days," writes Volcker. Embroiled in a nasty fight for the nomination, grappling by then with the hostage crisis in Iran and Soviet Union's invasion of Afghanistan, his popularity at an all-time low - this was the moment that Jimmy Carter finally got "his" recession. As quickly as he "decently" could, Volcker undid the credit controls. By July, they were gone. He also loosened the money supply temporarily to revive the economy. Meanwhile, the balanced budget was quickly jettisoned, as Congress added billions in additional spending to revive the economy. Interest rates plummeted, the recession ended almost as quickly as it had begun, and even the CPI slowed down for a few months, though not enough to prevent a second consecutive year of double-digit inflation

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"Please Don't Take It Away!" - *March 1981*

- People who could feel their standard of living slipping away tried to figure out ways to pull it back up. The most common way was to insert both spouses into the workforce; this was the moment that saw one of the seismic shifts in American life, the emergence of two-income couples. Wives joined the workforce by the millions, motivated in part by the need to keep pace with inflation. Whereas two-income couples made up a third of the nation's families in the late 1960s, a decade later, that number had risen to around 45 percent
- That houses went up in price was a direct by-product of inflation; hard assets always rise in inflationary times. That people began thinking about their homes in this fundamentally new way was a direct by-product of the fact that they were rising in value. People no longer bought a house so much as they "invested" in one; the down payment was their "equity stake"
- Thrift, for instance, had long been the great American virtue, something good people practiced as a matter of course. In a time of double-digit inflation, however, thrift was something foolish people practiced. Thrift in an inflationary

age meant paying for tomorrow's more expensive goods with yesterday's diminished dollars. It was dumb. Borrowing, on the other hand, meant purchasing yesterday's less expensive goods with tomorrow's inflated dollars. That was smart. "The buy-in-advance syndrome," one economist called it. Why did people continue to take on more debt when previous experience suggested they should be slowing down? Because borrowing was the economic response that made the most sense

- Strangely, despite the run-up in debt and the new attitudes engendered by inflation, bank credit card divisions were again losing money. For a few years in the mid-1970s most bank card operations were profitable; in 1978, according to Nilson's figures, banks made an average of $22 for every $1000 charged, a rate of return of just over 2 percent. There were two reasons for this new wave of losses. The first was that banks were just as vulnerable to the effects of high interest rates as any other business. Rising interest rates increased the cost of money for a bank just as it did for General Motors or IBM. But thanks to state usury laws, banks (unlike General Motors or IBMs) were prevented from passing on their higher costs to their middle-class customers. Only three states lacked usury ceilings in the late 1970s: Hawaii, New Hampshire and California. Although usury ceilings varied widely, from a high of 24 percent (South Dakota and Ohio) to a low of 10 percent (Arkansas), most of them ranged between 12 and 18 percent. Plainly, with the cost of money at or above the usury ceiling, profits were pretty much out of the question. Some savvy customers even learned how to take advantage of the disparity: by drawing a large cash advance against a bank card in a state with a low usury ceiling, and then putting that advance in a high-interest-rate money market fund, they could make a profit on the spread. This action infuriated bankers, but they were helpless to do anything about it

- Bankers had a word for people who paid off their balances each month: freeloaders. The way they saw it, the banking industry was providing a service of indesputable value. They were providing Americans - and people the world over - not only the means to trigger an instant, no-questions-asked personal loan, but also the means to walk into any decent-sized establishment, practically anywhere on the planet, and walk out with something they wanted simply by proffering a little piece of encoding plastic. Surely, that was worth *something*, even for those who eschewed the debt feature of the card. That so many customers paid nothing at all for the service cards rendered in linking buyer to seller caused the nation's bankers to feel, well, cheated

- Even as profits turned to losses in the late 1970s, no credit card banker was willing to make the first move to impose a fee. They all feared the wrath of legislators, of judges, of customers - and they feared each other. If Bank A imposed a fee, wouldn't Bank B respond by launching a marketing campaign to point out that its card was still free? It was a legitimate worry. There things stood - and there they would have continued to stand, except that in the spring of 1980, Jimmy Carter imposed his disastrous credit control program. Although bankers complained bitterly about the program, it wound up giving them the cover they needed to impose annual fees. "Jimmy Carter," Ken Larkin later admitted, "did us one of the biggest favors any President ever did the banking industry." Because the controls included a freeze on new accounts, Carter's action meant that for this

one moment, Bank B was prevented by regulatory fiat from soliciting Bank A's customers. By the time Volcker lifted the controls four months later, just about every bank in the credit card game had imposed a small annual fee - $10 or $15 or $20. The fees created a valuable new income stream for the banks, and ended the "freeloading" they so loathed. Millions of credit card customers all over the country reacted by pulling their business away from their bank; Bank of America lost several hundred thousand accounts to such protests. But the protests were futile, because when the protesters searched for a new "free" credit card, they discovered that they all now came with fees attached. The only other option was to refuse to take a credit card altogether, and though surveys suggested that as many as half the country's credit card users were vowing to do precisely that, they never did. By 1980, refusing to use a credit card wasn't much of an option anymore

- The middle class had discovered money market funds because the "real world" interest rates they offered, compared to the 5.25 percent interest Regulation Q allowed banks to pay, had become too large to ignore. In 1974, the widest difference between regulated passbook rates and unregulated money market rates had been about 4 percent. In 1980 and 1981, the spread between the regulated and unregulated rates could get as wide as 11 or 12 percent. Although they were technically investment vehicles, money market funds were now seen as basically turbo-charged savings accounts, a notion the fund industry did nothing to discourage. According to an SRI survey, by 1980, 42 percent of the nation's households "understood money market funds well enough to decide whether to buy one or not" - a tremendously high number for a product that had been virtually unknown until a few years before

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Mr. Regan Goes to Washington - *September 1981*

- When the consequences of Volcker's anti-inflation crusade were so painful that Americans were entitled to wonder whether the cure was worse than the disease. In attempting to squeeze inflation out of the economy, Volcker threw the country into the deepest recession since the Depression. Interest rates were off the charts. They had already risen to new heights during the last year of the Carter administration, but it was the summer of 1981 when interest rates peaked. The prime lending rate seemed to be stuck at around 20 percent. Government debt of every kind - three and six-month T-bills, as well as the "long bonds" of fifteen and thirty-year durations - were paying out stratospheric yields, around 16 percent in the case of Treasury bills, with the long bond hovering close to 14 percent. Most of the summer, the average money market fund yield was between 16 and 17 percent; in August, at least three funds broke the 18 percent barrier. In their whole history, they would never yield more than they did that summer
- Every month, the money funds at the top of the list were flooded with new money. Around this same time, a term came into vogue to describe this new phenomenon of Americans moving their money around from place to place, in search of an extra percentage point in interest. It was called "chasing yield," and it represented one of the great behavioural shifts in American finance

- It was obvious that money market funds were *still* able to offer higher interest rates than most banks and thrifts, primarily because their overhead was so much lower. The key advantage banks now had was federal deposit insurance. With the spread between bank yields and money fund yields having narrowed to one or two percentage points, instead of ten or twelve percentage points, there were plenty of people who were willing to forgo a little interest to get deposit insurance. But not nearly so many that money funds were destroyed: yield had become too important a goal for too many Americans. By the end of 1983, money market funds had dropped to $160 billion in assets. But then they began to rise again. By the end of 1984, money funds were above the $200 billion benchmark again, on their way to $400 billion and beyond
- And all the while, the Age of Inflation was winding down, as Volcker stuck to his tight money policy, and the country suffered through the wrenching recession of the early 1980s. Reagan did his part, too: when the nation's air traffic controllers went out on strike six months into his presidency, he took the kind of bold action Jimmy Carter never could. He fired them all. As cruel as this action was, it sent an unmistakable signal to both business and labor that the days of large, inflationary wage settlements were over. Companies could force tougher terms on the unions, and the federal government would not interfere. Whatever one thinks about this stance as social policy, as economic policy, it worked. The spiral of inflation was broken

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The Maestro of Magellan - *August 1982*

- The stock market didn't have much to offer people who were trying to ward off the corrosive effects of inflation. The stereotypical elderly investor, for instance, who traditionally held conservative stocks that paid out steady dividends, was far better off in a money fund, because the yield was much higher. A real speculator, of course, might be able to find a stock or two that could outsprint inflation, but for most people that course seemed awfully risky. By contrast, an investment in inflation-sensitive real estate seemed a sure thing
- Fidelity was a place that was starting to resemble a giant consumer goods company like Procter & Gamble more than a traditional provider of stock mutual funds. It was learning to think the way a classic consumer products company thinks - trying to find out, first of all, what the customer wants and then attempting to craft something that would scratch that particular itch. And it was beginning to use the same business strategies that had long characterized the giant packaged goods companies in America: finding niche products that satisfied different customer segments; developing "brand" awareness; emphasizing marketing and advertising. The only difference was that Fidelity was selling funds instead of soaps
- After two or three years as a stock researcher, an analyst is likely to get impatient if he isn't handed a fund. Again, Lynch was no exception. "I was starting to wonder if I was ever going to get a chance to play for the varsity," he would later say. Yet even though he spent eight years as a stock analyst, he never threatened to quit. It wasn't his style. "I just assumed things would work out," he says now

- The job of a Fidelity analyst - as it is for any stock analyst - is to cover a particular industry, and to make stock recommendations to Fidelity's fund managers. His first year as a full-time Fidelity analyst, Lynch was given the metal and chemical industries to follow. He was paid $16,000. The next year, he was bumped up to $17,000. In between, he turned down a job offer that would have paid him at least $55,000 - "maybe $75,000 if I earned the bonus." Why would he turn down a chance to quadruple his salary? Because the job would have meant moving to Wall Street, and Lynch was too much the Boston boy to do that
- Johnson did one other thing that would affect both Magellan's fortunes and those of the mutual fund industry. In opening Magellan to the public, Johnson decided to slap a small, 2 percent commission on it, making it the nation's first "low-load" fund. The difference between this commission and the commission the company used to charge in the old, Go-Go days - besides being much smaller - is that Fidelity got to keep the money itself instead of handing it over to a broker. The move itself was pure instinct. Johnson felt that if a fund truly performed, people wouldn't mind paying a small fee to get into it. Fidelity could then use that money to buy more advertising, and do more marketing and have more people to answer the phones. The loads that Johnson imposed on his funds became, in time, a cash machine, helping make him one of the wealthiest men in America, and helping create the behemoth that Fidelity became. Gradually, other mutual fund companies that sold directly to the public did likewise, and soon the direct-market mutual fund universe was divided into two groups: the no-loads - which, as the name implies, consists of companies that do not put any loads on the funds they offer - and the low-loads, of which Fidelity is the preeminent example

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The People's Nest Egg - *April 1984*

- That same 1981 tax bill contained a provision allowing any working person in America to lower his taxable income by $2000 simply by putting that amount in a special tax-deferred retirement account, known as an Individual Retirement Account, or IRA for short. At the time, no one really anticipated much interplay between IRAs and the stock market; it was generally assumed that IRA money would wind up in bank and thrift accounts. And at first, that's what happened. But over time, IRA money began gravitating away from banks and toward brokerage firms and mutual fund companies, drawn in part by the bull market and in part by a marketing blitz that dwarfed anything that had come before
- It is right to say that because the pool of capital that made up an IRA could not be withdrawn for twenty or thirty years, many people viewed their IRAs as containing money they could experiment with. They could use an IRA to buy their first stock or their first mutual fund. They could it in a money market fund first, and then, as they got bolder - and the bull market became more irresistible - shift some of it into something a little risker. (This pattern was a frequent one). IRAs gave people a way to try on the stock and bond markets for size, to see how they felt, and to become slowly comfortable with the idea of investing. The knowledge that the money couldn't easily be withdrawn acted as a psychological safety net, allowing investors to feel as though they could take a chance or two. If they made a mistake, they reasoned, there was still time to recoup - several decades perhaps

- The theory of discontinuity says the way you really make money, and establish a business, is not by doing what already exists, but changing it in some way that is so fundamental that consumers have to react to it. Disposable diapers versus cloth diapers, detergents versus soap, television versus radio - these are all discontinuities. In the financial world at that time, there were two discontinuities, one created by the government, and the other created by inflation. The discontinuity created by inflation caused people to question the way they were saving. The discontinuity created by the government, the IRA, gave them a different way to save. And the company could marry these two together could change the structure of the American savings system

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The Pleasure Palace in the Sky - *May 1984*

- 1980 was when the United States went from being the world's largest creditor nation to its largest debtor nation. If, in the early decades of the century, it was impossible for a working man or woman to secure a loan from a legitimate lender, in the 1980s he or she could hardly refuse one. The descendants, of the clientele of loan sharks became the valued credit-card 'members' of leading banks. In the 1980s the home equity loan proliferated, and personal bankruptcy lost its stigma
- If Hock had his way, Americans would one day carry a single card that acted as an "access device" - a card that gave customers a means to get at not just their deposits, but all their financial assets. The choice of which asset to use - "a credit asset, a deposit asset, an investment asset, a mortgage equity asset, cash value of life insurance, or any other asset, a mortgage equity asset, cash value of life insurance, or any other asset," as Hock once described it in a speech - would be "the customer's prerogative." Hock was convinced that this all-encompassing device would be so valuable that customers would willingly pay upward of $200 in annual fees for it - rather than the $15 or $20 they now so grumpily paid for credit cards. A card such as this one had the potential to place banking at the center of the financial lives of Americans again, the way it had been before all those other institutions began crashing through the walls of banking. It would forcefully bind a customer to his bank - though it was also true that bank no longer had to be the one across the street; it could just as easily be one across the country
- Hock launched Visa's first debit card in the mid-1970s; some five years later, only 130 banks marketed them. It wasn't so much that bankers were against the idea of debit cards. But they were violently opposed to the idea of a *Visa* debit card. They wanted debit cards that they controlled, not Dee Hock. And they wanted Visa and Hock as far away from their customers' deposits as possible. "As long as he kept to credit cards, banks were willing to give him leeway"
- Most debit card activity in America centered around ATM use, which grew rapidly in the late 1970s and early 1980s, and became as much a staple of American financial life as the credit card itself. In the beginning, most ATM systems were proprietary, meaning that customers could use their cards only in the very small handful of machines operated by their bank. This, of course, put severe limits on their usefulness, and led in time to the emergence of a wide variety of ATM networks, which linked machines in different parts of the country to a centralized

switch. Just as it had once taken years for a national credit card system to evolve - years of chaos and losses and wrong turns - so did it now take years for a clearcut nationwide ATM system to evolve - years that were, in their own way, chaotic and costly and full of wrong turns

- Visa's plans called for every ATM owned by a bank that was a Visa member to take any and all Visa debit cards - even if the issuing bank was across the street rather than across the country. For Hock, this was an unbreakable rule: no Visa member could exclude another Visa member's card. The entire system, he believed, stood on that principle of "universality." To bankers like Browning, however, it was completely unacceptable that an ATM machine owned and operated by Colorado National Bank would have to accept ATM cards issued by its Denver competitors simply because they were Visa banks. Browning was happy to have a California bank connected to his network, but he was damned if he was going to let a local bank in. All over the country, bankers felt the same way: competitive advantage was more important than universality. Since Browning's plan called for the member banks to be able to exclude local competitors from the Plus System, most bankers found Browning's proposed network far more appealing than Hock's
- The way you make a credit card profitable is very simple. You get people to borrow a lot of money. That is the most important thing. Secondly, you identify people who are likely not to become delinquent. And thirdly, you make it easy for them to get into debt
- The First Select card carried an interest rate that approached 22 percent when banks were charging 18 or 19 percent, for Kahr knew that "the most profitable customers are not very price sensitive." What they were sensitive to, Kahr also knew, was the minimum they had to pay each month, so while First Deposit was charging 22 percent interest, it was dropping the minimum payment to the lowest of any institution in the country. Requiring only the tiniest sliver of principal repayment, the First Select card more closely resembled the repayment structure of a home mortgage than a traditional credit card. Finally - and this was a classic Kahr twist, which he had first used at the Associates - in order to accept the card, one also had to accept a check from First Deposit that ranged from $1,000 to $3,000. This check served as a cash advance, and in its direct mail packages, First Deposit promoted the check as a way to pay off other credit card debt. The ostensible appeal to the consumer was that, although his total debt load would not go down (in fact, it would go up), the monthly minimum payment would be much lower than it had been - half as much in many cases. Of course the appeal for First Deposit was more clear-cut: the minute a cardholder cashed the check, he began paying interest. If the cardholder refused the check, he didn't get the credit card. That was one of the ways Kahr ensured that First Deposit's customers were "profitable"
- From his Wells Fargo experience, Kahr knew that there was a particular group of Americans who combined the two behavioral traits he was looking for: a willingness to use a credit card to build up debt, divulge who those people are, but from the veiled comments of others, one can make a calculated guess. They are most likely middle class, though not upper middle class. They're strivers, perhaps the first generation in their family to break into the white collar work

force. They live on the right side of the tracks, though perhaps a little closer to the tracks than they might like. They're young enough to harbor no fear of debt, though their station of life does cause them to fear for their credit rating, which is why they go to great lengths to avoid becoming delinquent. One source describes them as "the lower end of the yuppies, making good money, but spending ahead of their income, [yet] with a predictable ability to increase their income." For his part, Kahr will only concede that "we were never aiming at the affluent market." This same source adds that at most banks, the people who fit this description make up around 10 percent of the credit card portfolio. From a banker's perspective, however, they're the 10 percent who made money for the bank

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The Bull's Last Stampede - *January 1987*

- The Fidelity modus operandi during the 1980s was to keep a new fund under wraps for a short time, and observe how the fund manager did with the pocket change he had been handed without the whole world watching. Each trade the new fund manager made was closely tracked, and every move he made examined. Of course, Lynch had been watched at the beginning, but it was different then: it was Ned Johnson popping in to ask about this or that. Now there were formal meetings, during which the new fund manager was grilled by a handful of veterans: Why did you buy this stock? Why did you sell only a portion of that position?
- Second reason new funds were begun away from the glare of publicity: if things worked out the way they were supposed to, the fund manager would have an advertisable track record very soon after he began taking money from the public. To attract money into this unknown mutual fund, Fidelity could waive the load; such decisions were a key component on a 2 or 3 percent load, since most people didn't mind paying a small price to get into a hot fund. In time, this became the classic Fidelity marketing strategy
- Merrill Lynch was suffering, at least in part, from its unwillingness to completely embrace the logic of the money revolution - logic that it had first stumbled onto, years before, with its own CMA. That logic said that gathering assets would be the crucial skill once the regulatory barriers were dismantled. And that had indeed turned out to be the case. But at Merrill Lynch, despite having a large and well-run mutual fund division, the company still stressed commission revenue. So the brokers worked the phones the way they always had, making hundreds of cold calls, trying to persuade people to buy this stock or sell that one. Even pay a load as high as 6 percent to get into Merrill Lynch mutual fund, which was out of line with customer expectations - though very much in line with the expectations of the firm's brokers. In stressing commissions, and pushing brokers to make cold calls, Merrill Lynch was misreading the new middle-class investor. The new investor was reading *Money* magazine and watching Louis Rukeyser. The new investor had learned that he had to start taking responsibility for his own financial life. If the new investor was going to make a mistake in the market, it would be his own mistake, rather than a mistake some broker put him into

“This Is a War over Here” - *October 1987*

- As the meeting drew to a close, a young woman, new to Fidelity, suddenly asked for a straw poll on when the bull market would end. It was an embarrassing moment. Every fund manager in the room suddenly looked down at his shoes. The young woman persisted. Again the assembled portfolio managers demurred, more firmly this time. Here were seventeen market experts, the very people the middle class had come to rely on to guide them through the money revolution, each one of them working the bull market for every last dime. Yet they were no longing willing to look the thing square in the eye
- One of Peter Lynch’s favorite factoids, which he loved to trot out when visiting journalists came calling, was that between 1955 and 1985, the market dropped some 1500 points - Mondays. The Monday decline phenomenon fit all too nicely with one of Lynch’s pet theories, which is why he trotted it out so often: Americans, he believed, did too much “negative” thinking, which affected their ability to be objective about buying and selling stocks. “The reason for the Monday decline,” Lynch would assert, “is that on the weekend everyone becomes an amateur economist.” They read the gloomy articles in the Sunday papers, and became gloomy themselves. Naturally, when the market opened on Monday, they wanted to sell. “It’s no coincidence,” Lynch would later add, “that in 1987, the market crashed on a Monday”

Peter Lynch’s Long Good-bye - *March 1990*

- *I’m still willing to take the risk.* Here, surely, was the key to everything: here was what separated the 1987 market crash from all the bear markets that had come before it. Always before, the ugly aftermath of a long bull market had been accompanied by the second of scurrying feet, as panicked small investors turned tail and ran as far from the market as they could. But after the crash of 1987, small investors did not turn and run, at least not in huge numbers. The New York Stock Exchange, in one of its regular shareholder surveys, found almost no drop-off in the number of stockholders in the year after the crash. The fund companies all noticed the same thing: new sales were slow, and business was sluggish, but customers simply did not flee the way they had feared. They *moved* their money, in ways that reflected a new caution, shifting assets from an aggressive fund to a less aggressive one, from an equity fund to a bond fund, from a bond fund to a money market fund. But they kept their assets in the company
- What Schwab’s ordeal probably proved was that in the face of hard times, vision and foresight - which Schwab demonstrably had - needs to be accompanied by competent management - which Schwab demonstrably lacked. Schwab suffered not because it hadn’t grabbed onto the money revolution with sufficient fervor, but because it had performed miserably in the crash. When telephones aren’t answered for days at a time, when the orders that are taken aren’t executed promptly, when the entire firm seems to be having a nervous breakdown at the very moment customers are most dependent on it - that’s not the sort of thing people tend to forget. In the past, customers had always been forgiving of Schwab’s lapses. This time, they weren’t

- Was it inevitable that some money fund manager was going to stretch too far in pushing for a little extra yield? Probably. That, too, would seem to be one of the immutable laws of investing - though it's more likely one of the immutable laws of human nature. Someone always takes a good idea too far, and ends up losing instead of gaining. And so it was that on two separate occasions, once in the spring of 1989 and again in the spring of 1990, A2-rated corporate paper held by a handful of money market funds defaulted. As a result of these defaults, the money funds in question were in danger of "breaking the dollar" - that is, dropping to 99 cents a share, and costing investors some principal for the first time ever. If that were to happen, the money fund industry would be faced with the prospect of seeing its worst nightmare come true. This also explains why, when it came down to it, the companies whose money funds held the defaulted paper were unwilling to take their chances and let events play themselves out. Every single fund company involved chose not to let its money market fund absorb the loss. Instead, the parent companies purchased the defaulted paper from their money funds at face value, so that the parent, not the money market fund, would be the one tagged with the loss
- Only if investors continued to believe that money funds were safe - and not just safe *but as safe as bank accounts* - would they continue to feel comfortable pouring their savings into them. In a weird way, money funds did turn out to be insured after all. It was the discipline of the marketplace that insured the funds, the palpable fear that allowing a money fund investor to lose principal could bring the entire industry tumbling down. In some ways, this fear served customers better than deposit insurance
- It was easy to envision Magellan shareholders, upon hearing the news about Lynch, pulling assets out of the fund in a wild stampede. But that didn't happen. Instead, Magellan shareholders took the news with remarkable calm. When Fidelity's marketers did focus group research after the Lynch announcement, they discovered, to their immense relief, that the vast majority of Magellan shareholders were inclined to be patient; they would give Lynch's replacement time to prove himself before deciding whether to stay in or get out. This would also give Fidelity time to prove itself, to show that its pool of talent went deeper than Lynch, and that the company was far more than one supremely gifted fund manager. Of course it wouldn't hurt if the person Ned Johnson picked to be the new Magellan manager turned out, somehow, to be the *real* "new Peter Lynch." But who could know for sure?

The Triumph of Main Street - *August 1993*

- With the exception of one year, 1990, inflation was no longer the dominant economic motif - disinflation was. This was partly due to the recession that took hold in 1992; facing hard times, people weren't willing to pay ever-higher prices, and undertook to find less expensive alternatives. But it was also due to trends that were in evidence even after the recession had ended. The new global economy, the enormous economic power of discounters such as Wal-Mart, the move away from "name" brands and toward generic products - these were all factors that exerted a downward pressure on prices. Fast food restaurants,

having saturated the country, were forced to compete with each other by lowering prices. Cheap generic cigarettes began cutting deeply into the market share of the big, established brands, forcing companies like RJR Nabisco and Phillip Morris to lower prices on well-known brands such as Winston and Marlboro. A vicious price war broke out among computer manufacturers. The price of gasoline at the pump in 1993 approached prices not seen since the late 1970s. There were dozens of similar examples. Even the price of a house was not immune from this trend. After almost twenty years of spiraling upward, housing prices finally stopped rising in many sections of the country. In some sections, they actually went down. By all rights, Americans should have been rejoicing at this turn of event. But many weren't. Homeowners, in particular, were dismayed when they had come to view the built-in capital gain provided by a 10 or 15 percent annual rise in the price of their home as practically God-given right. But there was no such right. Houses were commodities. They reacted to the laws of supply and demand. And, as with every other aspect of personal finance in America, buying a house meant taking some risk. To their chagrin, millions of Americans were now relearning this most basic of truths

- Ultimately, AT&T's entry into credit cards has turned out to be an enormously important event. Never mind that by 1992, AT&T was the second-largest issue of bank credit cards, behind only Citibank. Or that is initial, successful foray into credit cards has been followed by similar moves by other large, well-known industrial companies, most notably Ford and General Motors. Or that nonbanks now control a remarkable 43 percent of the gross volume of Visa and MasterCard charges - up from 7 percent in 1987. Of far more moment, the AT&T entry has completely changed the dynamics of the credit card business - to the detriment of the nation's banks, but to the great benefit of the nation's consumers. Once AT&T stripped away the annual fee, banks had to do likewise. They tried to hold the line at first, but as they saw customers slipping away they quietly began trying to hold on to them by offering to waive the annual fee. By the spring of 1991, James Grant reported in *Grant's Interest Rate Observer*, it was not uncommon for a customer to call his credit card bank, planning to cancel his card because he had acquired a no-annual-fee card, only to be told, "In the interest of customer service, we'll waive the fee for this year." Soon thereafter, a number of banks began publicly trumpeting their new no-annual-fee policy. Thus did the banks try to turn lemons into lemonade. Did elimination of annual fees cut into the bank profits? You bet it did. One authoritative study conducted in late 1990 concluded that "annual fees represent the difference between profit and loss on a per-account basis" - that's how important they had become to the business. "No-annual-fee" offers not only stripped banks of a key source of revenue, but they also attracted precisely those customers most banks didn't want: the ones who paid off their balances each month. In late 1991, Spencer Nilson reported that convenience users would "cost" the banking industry $1.21 billion that year
- "I've said before that an amateur who devotes a small amount of study to companies in an industry he or she knows something about can outperform 95 percent of the paid experts…." He wrote. He wrote those words, as it happens, in his second best-selling book, entitled *Beating the Street*, which he worked on after retiring from Magellan, and which, by March of 1993, he was busily promoting