A REVIEW OF LITERATURE ON HOW PROFESSIONAL SPECULATORS VIEW THEIR ROLE IN FINANCIAL MARKETS AND THE CAPITAL FORMATION PROCESS

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Abstract

This paper examines how professional speculators view their role in financial markets and the capital formation process. Though they are often vilified by the public and media as greedy parasites wreaking havoc on financial markets and economies, an examination of their views reveals they perceive their endeavors as more noble. They view themselves as an essential element in the capital formation process by providing liquidity and efficiency to financial markets. Through the art of balancing supply and demand, they regulate financial asset prices, keep financial markets efficient, and facilitate the process of capital formation and economic growth. Periodically, professional speculators experience large financial losses when complex highly leveraged trades do not turn out as planned. Professional speculators, who claim to be regulators of fair pricing, have a responsibility to monitor their actions and to be extra vigilant not to cause irreparable financial damage to themselves and other members of society. (JEL G20)

Introduction

For centuries the speculator has been associated with the misfortunes of countless markets and blamed for the financial ills of many due to the huge profits the speculator enjoys. In Gregory Millman’s book The Vandal’s Crown (1995), speculators are accused of currency manipulation and the destruction of the economies of many countries. Investors accuse speculators of being reckless gamblers that are the cause of their misfortune when investments go bad. Are speculators evildoers that cause destruction and swindle many out of millions of dollars? In the speculators’ view, the answer is no. Speculators or “professional traders” are not gamblers. Gambling involves elements of chance and haphazard guesses as to the direction in which the chips may ultimately fall. Speculation involves decisions based on precise calculations and sound reason.

Many times throughout history it has been governmental intervention that has caused the downfall of markets and chaos in society, but the speculator took the fall. To legendary speculator George Soros, “when speculators profit, the authorities have failed in some way or another. But they don’t like to admit failure; they would rather call for speculators to be hung from lampposts than to engage in a little bit of soul-searching to see what they did wrong” (Soros 1995, p. 84).

Examples of regulation gone awry, resulting in the disgrace of speculators, dates back thousands of years. In Rome the Emperor Diocletian in 300 A.D. tried to punish speculators for withholding goods from the public to receive higher prices as demand grew. Diocletian created a law that anyone trying to sell goods higher than prices he set himself would be killed. Suppliers refused to bring their goods to a market that did not supply reasonable prices, and the result was famine and the deaths of many. The law was eventually repealed (Niederhoffer 1989, p. A10).

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Another example of governmental intervention in the markets resulting in societal chaos was in Antwerp, Belgium, in 1858 when the Spanish seized the city’s port. The Spanish blockaded the port hoping for surrender when supplies ran out. Bakers and farmers produced large quantities of bread, and smugglers helped to provide needed supplies. Speculators assumed bread would be scarce and drove up prices as did the manufacturers and smugglers. The government perceived the profits of the speculators as an injustice and imposed laws with price caps and strict penalties. The smugglers ceased to bring supplies due to the lack of reward for the risk. Eventually supplies ran out, and Antwerp had to surrender (Niederhoffer 1989, p. A10).

It is human nature to accuse others of causing one’s misfortunes, and speculators are often accused due to the nature of the business. Speculators provide the other side of the bet in the game of supply and demand. If the majority believes that the outcome will be heads, it is the speculator who takes the bet that it will be tails. Speculators are essential in providing liquidity and efficiency to financial markets by regulating prices through the art of balancing demand and supply and thus facilitate the capital formation process.

Speculation Defined

Speculation is often associated with gambling. However, there is a clear distinction between gambling and speculation. Dickson G. Watts, the author of Speculation as a Fine Art and Thoughts on Life, distinguishes gambling from speculation. He states, “Speculation is a venture based upon calculation. Gambling a venture without calculation” (Watts 1965, p. 7). Watts further remarks that gambling involves blind chance but speculation presupposes intellectual effort. He claims that the law distinguishes between the two by condemning gambling and permitting speculation (Watts, p. 7). Merriam-Webster’s dictionary defines speculate as (1) “to think or wonder about a subject”; (2) “to take a business risk in hope of a gain” (“Speculate”). However, investor icon Philip Carret, author of The Art of Speculation, defines speculation as “the purchase or sale of securities or commodities in expectation of profiting by fluctuations in their prices” (Carret 1997). Speculation is not just gambling; it is a calculated, planned business risk with the expectation of profits through the volatility of prices.

Speculators are often vilified in the press and associated with scandals. Whenever the financial markets have huge declines, the blame is placed on the speculator. However, when the markets are moving upward and everyone is making money, no attention is drawn to the speculator. The speculator by nature is bearish, always betting against the majority. This is unpopular in a society focused on optimism. Because speculators reap financial gains when betting against the majority, the average investor feels that speculators do not contribute to the welfare of the world but only to their own pockets. This continual condemnation has even confused some professional traders, resulting in the shame felt by some speculators regarding their chosen profession. Andy Krieger, whose illustrious career is chronicled by Partnoy in his book titled “Infectious Greed,” quit a job in 1987 because he could not answer for his young son the question of what good his job does (Niederhoffer 1989). However, Victor Niederhoffer, a leading hedge-fund manager in the 1980s and 1990s, defines speculation in his book The Education of a Speculator as follows:

I am a speculator, and my daily bread depends on reversing big moves. In economic terms, my function is to balance supply and demand. I sell when prices are high and buy when prices are low. When prices are too high and consumers want to exchange cash for goods, I take their cash and let them have their goods. I prevent shortages by pushing prices down so consumers don’t have to pay up. Conversely, when prices are down and producers want cash badly for their goods, I give them the cash and take their goods. In these bad times, I keep producers from going broke, and prevent waste and spoilage by bringing prices up.
I’m like a dynamic refrigerator, or a captain rationing food on an unexpectedly long voyage (Neiderhoffer 1997, p. vii-viii).

Dr. Niederhoffer realizes that speculators are not right all of the time, which can lead to shortages or gluts in supply, causing panic such as the Dutch Tulipomania in the 1630s, the South Sea Bubble in London in 1720, and various other market crashes over the centuries. However, he feels that because speculators are specialists in the field of prices relating to supply and demand, it is the speculator who is best at keeping markets in balance instead of lawmakers. Speculators pay out of their own pockets when making a mistake, as opposed to the politicians and lawmakers who are not held personally liable. Who is more likely to learn from the mistake? This is why speculators are necessary in the marketplace, left to do what they do best. Niederhoffer states “man cannot live on bread alone, but without speculators there would be no bread” (Niederhoffer 1989).

The Speculator’s Role in the Capital Formation Process

The capital formation process involves the transfer of savings to investment through the movement of dollars from a surplus economic unit to a deficit economic unit. This process occurs in the financial markets, and these markets provide businesses with the ability to expand and grow, creating economic growth for society. By assuming risk, the speculator provides liquidity and helps the markets to function more efficiently. In many respects, all investors and businessmen are speculators. By definition speculation is a business risk with the hopes of a gain or profit. The person who runs a business and assumes the risk to be in business is essentially a speculator because the outcome is uncertain. The investor that provides capital to businesses or the government in exchange for a return above inflation is also a speculator. The businessman, the investor, and the professional trader are all speculators who facilitate economic expansion.

The capital formation process could not occur without speculation, but it is the professional trader, through the assumption of risk, who provides the balance of supply and demand as well as liquidity and efficiency in the markets that move capital. The balance of supply and demand is best explained by Niederhoffer:

I try to predict the prices of common goods a day or two or a few months in the future. If I think the price of an item will go up, I buy today and sell later. If I think the price is going down, I’ll sell at today’s higher price. The miracle is that in taking care of ourselves, we speculators somehow ensure that producers all over the world will provide the right quantity and quality of goods at the proper time, without undue waste, and that this meshes with what people want and the money they have available (Niederhoffer 1989).

Speculators provide liquidity in the secondary markets because so many of them are willing to buy and sell what the market has to offer. The more buyers and sellers there are for a commodity or security, the easier it is to convert the investment to cash. Liquidity reduces risk and encourages investment, thus promoting the capital formation process. According to Austrian economist Murray Rothbard, author of Man, Economy, and State, speculators help to achieve market efficiency and price stability. He states, “The market tends inexorably toward the establishment of the genuine market-clearing price. Speculation reduces the gap between the high prices and the low prices. Far from causing greater fluctuations, the speculator tightens the band around which prices may fluctuate and provides stability” (Mayer 1999). Carret further explains that market efficiency is achieved by speculators who best allocate resources to their highest uses through buying and selling. Speculators accomplish this by “opening reservoirs of capital to the growing enterprise, shutting off the supply of capital from enterprises which have not profitably used that
which they already possess” (Mayer 1999). According to this view, it is the speculator who directs capital to its best uses and regulates the capital formation process.

Hedging is another important factor in the capital formation process. Speculative trading promotes economic well-being in the market by allowing hedging and risk transference. Hedging provides companies the ability to reduce and manage their exposure to the risks associated with interest rate, commodity price, and exchange rate fluctuations. The ability to manage risk reduces the probability of financial distress that firms face. The speculator takes the other side of the hedge, providing liquidity in the futures market. It is the speculator that gives firms the opportunity to hedge against risk and guard against market volatility. This provides a more stable environment for firms to create jobs. By allowing firms to hedge away risk, the speculator helps to lower the cost of capital to a firm, which facilitates economic growth and enhances the capital formation process.

Speculator’s Impact on World Markets

The world’s financial markets were once separate entities. However, technology over the past 20 years, including the implementation of derivatives, has closed the gap between markets. All markets are now connected in some way, with geography and regulation no longer separating the boundaries of markets. Trader Paul Tudor Jones, in the documentary video titled Trader: The Documentary, describes the world marketplace by stating, “Currencies, crude, stocks and bonds are all interrelated. The whole world is simply nothing but a big flow chart for capital” (Trader: The Documentary 1987). The interrelation of all of these markets provides a large playground for speculators. Currency traders move trillions of dollars around the world daily. This high volume can make or break an emerging market economy in the blink of an eye. Speculators have often taken the fall for the collapse of currencies in emerging markets such as the peso in Mexico and the Japanese government’s inability to stop the collapse of the Tokyo stock market in the 1990s. In 1992 George Soros earned $1 billion in a few days while pushing Great Britain out of the European Monetary System’s Exchange Rate Mechanism (ERM). Soros’s fund shorted sterling, causing the Bank of England to raise interest rates, which forced Great Britain out of the ERM. The tabloids dubbed Soros “The Man Who Broke the Bank of England” (Millman 1995). Gregory Millman suggests that traders have the ability to render economic justice through the use of an efficient mechanism: things sell for a true, free-market price. He further states, “Traders now have an unprecedented degree of power to sweep the financial foundation out from under poorly managed, politically unstable, or uneconomic governments before the bureaucrats even know what has happened” (Millman 1995, p.ix-xiv).

The Ludwig von Mises Institute, which is the research and educational center for the Austrian School of Economics, disagrees. An article published on the institute’s website states: “Speculation reveals quickly the underlying weaknesses in a market and affirm the buying public’s approval or disapproval. The currency collapse of many Asian nations in 1998 revealed concrete weaknesses in the economic and political environment and were not caused by speculation” (Mayer 1999). It is the speculator that warns investors of the weaknesses in markets and provides financial discipline throughout the world by forcing financial law and order through pricing.

Governmental Influences on Speculation

Speculators are often blamed for market crashes and large investor losses. Whenever a market crashes and the majority of investors lose money, there is always a public outcry to hold someone accountable. The politicians make the public happy, capitalizing on these events by trading votes for policy changes. Unfortunately, it is often the speculator who pays the price for these actions.
An article by Phred Dvorak explains that Japanese financial regulators are trying to ensure that the country’s weak stock market operates properly. In doing so they are planning to, among other things, limit proprietary trading (Dvorak 2003). On August 15, 2000, the Securities and Exchange Commission adopted Regulation FD, which gave a 10-share owner the same rights to company information as a million-share holder, taking away the advantage the speculator has in knowing information about the companies in which they hold investments. A hedge-fund manager at greatspeculations.com writes, “The SEC’s attempt to BRING the liberal democratic elite view of ‘democracy’ to the equity markets has in fact REDUCED liquidity, driven down both the value and the numbers of new equity raised via IPO (initial public offerings) and increased the BREAKEVEN costs for new ventures: this by driving down previous HIGH VALUATION multiples...now 50% lower than before the SEC action.” The author further writes, “American speculators, and indeed world speculators, have given America great markets to raise capital for innovation and economic growth. But liquidity isn’t a given—and no one has the right to ask any trader to lose money for some harebrained idea of fairness or political correctness or multiculturalism” (Mr. E. 2001). Government regulation often is at the expense of the speculator. However, it is speculators that regulate the markets, and despite bureaucratic attempts to put reigns on them traders have been able to continue to dictate prices.

In a paper titled “Volatile Financial Markets and the Speculator” presented at the Economic Issues Lecture to the Royal Economic Society Annual Conference in 1998, Paul Davidson discusses the Keynesian view of economics and whether a transaction tax should be imposed by the government on speculators to decrease volatility and better protect the financial markets from crisis. The argument for the tax is based on the concept that, through statistical probability, calculations of future conditions can be estimated (Davidson 1998). However, the Long Term Capital Management debacle in 1998 showed that the brightest Nobel Prize winners in economics could not accurately determine future financial market conditions with statistical precision. Financial markets are greatly influenced by investor sentiment, making accurate and consistent prediction difficult if not impossible. In the film Trillion Dollar Bet, which chronicles the downfall of long-term capital management, Phillip Fisher says it best: “Math doesn’t drive financial markets; people drive financial markets, and people are not predictable” (Trillion Dollar Bet 1999). Governmental regulation of speculation would only provide less liquidity in the markets. When bureaucrats and politicians attempt to regulate an intricate network of markets that they do not fully understand, speculators are quick to react. An example of this is the October 19, 1987, stock market crash of 22.6 percent. The weekend prior to the crash, Treasury Secretary James Baker threatened West Germany that he would let the dollar drop. Dr. Niederhoffer describes the traders’ response to Baker’s attempt at ruling the markets: “Traders sent such a signal on October 19, 1987, when they dropped the wealth of the non-Japanese speaking world by 10% in one day when a modern-day king tried to interfere with the natural order by driving the dollar down one last 5% or so” (Niederhoffer 1989). In the same article Niederhoffer also explains that the most positive impact speculators have on the capital formation process is the ability to place checks on governmental policy that can lead to high inflation through the trading of bonds, thus controlling interest rates. The liquidity of the global financial markets should be left to those who understand the art of balancing demand and supply—the speculators.

**Dangers of Speculation**

Speculators play an important role in the capital formation process by regulating prices and controlling demand and supply. However, traders are human, and humans make mistakes. Corporations and institutions utilize proprietary trading to hedge risks and to create earnings in down economies. The traders for these firms can make mistakes, and when left unchecked have led to bankruptcy. It is the shareholders and individual investors who pay the price of these
mistakes. In the case of Nicholas Leeson, a trader for Barings PLC, an investment bank in the United Kingdom, Leeson managed to conceal losses of more than $1 billion before Barings discovered his trail of deceit. By the time the mess was sorted out, Barings owed losses more than double its equity, rendering the firm insolvent (Madura 2003, p. 397). Even a division of the prestigious J.P. Morgan involved in currency trading was shut down in 2003 due to disappointing returns (Zuckerman 2003). Further, hedge-fund managers and proprietary traders with large sums of capital to move in the markets can intertwine trades so complex that it is possible to bring down whole economies. In the case of long-term capital management, the bets were so big and backed by so little capital that when tides turned against the fund it had to fold on nearly $1.25 trillion in positions. This amount was so enormous that a global economic meltdown was a possibility. The Federal Reserve had to call financial regulators around the globe to bail out the fund (Trillion Dollar Bet 1999).

Speculation can be a dangerous game when the bets are not properly hedged to reduce risk. Hedge-fund managers risk not only the money of their investors but their own wealth as well. There have been numerous examples of professional traders who have lost their clients’ money and much of their own personal wealth. Professional speculator Victor Niederhoffer, who reigned as a top-rated hedge-fund manager for nearly 20 years, was forced to close down his $130 million hedge fund in 1997 after he could not meet margin calls (Jereski and Luchette 1997, p. C2). When egos enter into the speculative game, the results can be disastrous. In an article titled “The Continuing Education of a Speculator” by Mark Etzkorn (2003) in Active Trader magazine, Niederhoffer explains his fall from grace. Victor claims it was his ego that led to the collapse of his company and his personal wealth as well. After being the best in the business for so many years and participating in a heated competition with a Canadian fund, Victor took huge risks to remain on top and did not heed his own advice about risk control from his book The Education of a Speculator. The game of speculation involves high rewards, but with those come high risks. Therefore, it is the responsibility of the professional trader to proceed with caution because in the vast ocean of financial markets there are no life preservers.

**Summary and Conclusion**

Speculation is a calculated business risk with the expectation of profit through the exploitation of price volatility. Professional speculators are essential in providing liquidity and efficiency to financial markets. They help allocate economic resources to their best uses through the art of buying and selling financial assets and, by their volume of trade, provide liquidity to the markets. This allows firms to hedge away risk and helps to lower the cost of capital, thereby facilitating economic growth and improving the capital formation process. It is the speculator who warns investors of weaknesses in markets and provides financial discipline throughout the world by forcing financial law and order through pricing. Perhaps the most positive impact speculators have on the capital formation process is the ability to place checks on governmental policy through the buying and selling of currencies and bonds, thus preventing inflationary excesses. Speculation does not come without dangers. Proprietary traders with large sums of capital can engage in trades so complex that it is possible to bring down entire economies as well as their own empires. Therefore, it is the responsibility of professional speculators, who claim to be regulators of fair pricing, to monitor their actions and be cautious not to wreak havoc on themselves and other members of society.
References


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