A Piece of the Action - How the Middle Class Joined the Money Class

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Joseph Nocera's "A Piece of the Action", traces how middle class America got from being credit and savings agnostic to embracing the same. Mapping out the economic and investment landscape of the latter half of the 20th century, Nocera's book sheds light on the role of double-digit inflation in the 1970's in making middle-class households interest-rate conscious, the inventions of restless financial revolutionaries and financial deregulation. Written with flair and deep insight, it is a book that every participant of the financial market must read.

Key takeaways

- While credit cards had a bit of a rocky start, the Great Inflation of the late 1970s and early 1980s encouraged middle class America to abandon thrift and embrace debt.
- Charlie Merrill, the founder of the firm Merrill Lynch strongly believed that financial education can convince the average American to invest in stocks and bonds.
- Government regulations imposing a cap on interest rates offered by banks on deposits were instrumental in the acceptance of money market mutual funds.
- Mutual Funds gained further acceptance due to the promise of future yield.
- The idea of “non-banks” was an ingenious way for institutions to side-step the hurdles set up by regulation.
- Innovation in financial instruments enabled middle class America to save, invest and consume better.

The birth of the ubiquitous credit card

The money revolution really started way back in the 1950's, although this is now obvious only due to the benefit of hindsight. At that time, the laws in America mandated that all banks pay the same interest on passbook accounts, which were the primary vehicle for middle class savings. In the 1950s, the rate never climbed above 3%. The law also mandated that checking accounts carry no interest at all. At the same time, other alternatives for middle-class savings were largely non-existent. Since there was nothing to differentiate one bank from another, most people chose the bank that was most convenient. However, it wasn't just the law that kept away middle class investors; it was also a great deal of snobbery. Up until the 1970s, when alternatives to passbook accounts finally forced banks to pay attention to their middle-class customers, most bankers looked at middle class business with disdain. In the banking world of that time, banks only valued the business from corporations, not consumers. Making loans to large companies was the most prestigious activity in all of banking; making consumer loans, on the other hand, was considered slightly disreputable, and such loans were ceded to finance companies, which was also considered slightly disreputable.

Bank of America was different, and it changed the way Americans saved and consumed. It eagerly embraced the middle-class customers that other banks looked down their noses upon. The result of that was the consumer credit card that Americans eventually embraced with a fierce vengeance. One day, back in September of 1958, the unsuspecting citizens of Fresno, California became the subjects of a corporate experiment that was to transform the financial services industry and the habits of tens of millions of Americans and countless others around the world. On that day, Bank of America air dropped on 60,000 unsuspecting citizens, a piece of blue and orange plastic about the size of a business card emblazoned with the less-than-catchy name, BankAmericard, now better known as VISA. This card gave them a chance to avail of what amounted to a small unsecured personal loan. The credit card had arrived and with it consumerism, consumer indebtedness, and consumer bankruptcy took new leaps forward. The Visa company, as we know it today, was actually a last ditch effort to save the failing BankAmericard franchise system. When BankAmericard was rolled out across the country, no one really gave much thought to the need to govern the relationship between issuing banks, especially when customers used cards outside the purview of the issuing bank. Back then, banks started to cheat each other and the system was close to failure when a fellow called Dee Hock at Bank of America suggested the creation of a governing body which at some point evolved into the Visa company that we know today.

Bringing Wall Street to Main Street

Charlie Merrill, the founder of the firm Merrill Lynch had a very simple dream. He wanted to "bring Wall Street to Main Street". Considered to be the greatest populariser of the stock markets, he spent his entire career trying to convince the middle class that stocks and bonds should be a part of their lives. His central idea that the middle class should be investors as well as savers, lies at the heart of the money revolution. Merrill believed that in the long-run, Wall Street would not prosper unless it broadened its horizons. At that time, the stock and bond markets were completely an insider's game, scorning small investors. A survey at that time found that small investors looked at the stock markets with suspicion and mistrust. In order to change peoples' perception, Merrill launched a massive public relations campaign that far outlived him. In addition to positioning Merrill Lynch as a broker that operated on a higher moral ground than his less scrupulous competitors, the campaign also focused on reacquainting the Americans with stocks and bonds. Merrill held the belief that people would not come to the stock market unless they understood it. He regularly wrote articles educating small investors about the stock markets and encouraging them to invest their money in stocks and bonds. He was a believer in the virtue of long-term investing and was outraged whenever he overheard one of his salesman encouraging someone to buy a stock to make a fast profit.

The Age of Inflation

Inflation scared the American people like never before. The Great Inflation, the period between the later 1970s and early 1980s had a profound impact on middle class America's relationship with money. Of the many ways that Americans adapted to inflation, two changes stood above the rest. The first was a pronounced shift in the attitude of the middle class, particularly those young enough to have missed the depression, towards credit and credit cards. The thrift and risk aversion that stemmed from the depression era was finally abandoned during the raging inflation of the late 1970s and early '80s. Faced with double-digit inflation, volatile interest rates and a falling standard of living, consumers took respite in debt. Americans began borrowing as they had never borrowed before – borrowing that was facilitated by the near universal acceptance of credit cards, a condition that had arrived by the late 1970s.

The second was a shift away from regulated bank passbook accounts and toward "savings" vehicles that offered market rates of return. A large number of Americans finally realised that the biggest threat to the stability of their financial future was Regulation Q, which banned banks from raising interest rates even as "market" interest rates were rising rapidly. This was when the imperatives of inflation finally shook the middle class into action. The result was a swarm of people moving their savings out of bank passbook accounts and into money market funds.

It was also the moment when it was clear beyond all doubt that the money revolution had arrived. The emergence of two-income couples, adjustable-rate mortgages, credit cards and the middle class's growing participation in stocks, mutual funds and money-market accounts defined the money revolution.

It is important to understand that that money market mutual funds might never have come into existence in the 1970s if it had not been for Government regulations that kept an unrealistic cap on the interest rates that banks were allowed to pay. It was only a matter of time before depositors would get frustrated due to the Government imposed interest rate ceilings prevented them from getting market yields on their savings. Even banks that wanted to pay market rates in order to keep their old depositors, or attract new ones, were not allowed to do so. Bank certificates of deposit carried market interest rates only if they were in denominations of USD 100,000 or larger. Small depositors who had probably just a few thousand dollars to invest turned to Treasury bills to get a better yield. However, not wanting to give a breather, the United States Treasury countered by raising minimum bill denominations from USD 1,000 to USD 10,000.

In that atmosphere of frustration, money market mutual funds gave renewed hope to the American middle class. These money market mutual funds gathered together the funds of many small savers, in batches as small as USD 1,000, and then packaged them into larger bundles to meet the minimum denomination requirements of certificates of deposit, Treasury bills and other money market instruments. At that time, these money market mutual funds were free to offer competitive interest rates.

Mutual Funds knocking on Middle America's doors

By the fall of 1982, the Age of Inflation had effectively come to an end. That year, the Consumer Price Index rose a meagre 3 percent, and except for one year, stayed in the general range for the rest of the decade.

The Great Bull Market of the 1980s – the second greatest bull market of this century, and the event that most dramatically shaped personal finance as Americans emerged from the Age of Inflation – began in the middle of August 1982. During the Age of Inflation, Fidelity earned the distinction of becoming a company that eschewed commissions. It started marketing its money funds directly to the public, without relying on a commissioned sales force. Fidelity's Ned Johnson changed the structure of the markets by completely abandoning commissions on Fidelity's other funds as well, and began selling them all directly to the public, cutting out the traditional broker-dealer network. This happened in 1979. In doing so, Ned John finally brought "Wall Street to Main Street". Fidelity executives began to believe that their real function was not trading stocks, or researching companies, or even selling mutual funds. Instead, it was gathering assets. Another consequence of this direct selling was that Fidelity began relying heavily on technology. What Fidelity essentially learnt from the Age of Inflation was that "yield sells". With

this mind, Fidelity opened its flagship fund, the Magellan Fund managed by the star fund manager Peter Lynch, to the public in the summer of 1981. It was selling, much like the rest of the mutual fund industry at that time, that the manager running this wonderful fund would be able to keep churning out these fabulous returns. People were more than happy to buy this idea. The phenomenal success of mutual funds in the 1980s was built almost entirely on the promise of future yield, which in turn was based on past performance.

The birth of Non-Banks

Andrew Kahr, the inventor of Merrill Lynch's cash management account and the Schwab One Account, devised the ingenious concept of a "nonbank bank. The "nonbank bank" idea had enormous ramifications for the financial services industry. Most of all, it undermined the functional separation of commercial and investment banking, a bedrock financial principle that had been sacrosanct since the enactment of the Glass-Steagall Act in 1933. As per the statutes of the act, commercial banks were defined as institutions that both accept demand deposits and make business loans. However, Mr. Kahr came up with the ingenious idea that by dropping one of these functions, usually the making of business loans, institutions could transform themselves into "nonbank banks". This would enable them to continue their core business of dealing in checking accounts but would ensure that it is no longer by the numerous Government restrictions that had historically confined the activities of commercial banks. Once the Federal Reserve Bank gave its reluctant approval to the "nonbank bank" concept, the floodgates literally opened. Financial institutions went on an innovative spree, creating structures and partnerships previously unheard of. The Bank of America promptly acquired Charles Schwab & Company, a discount brokerage house; Merrill Lynch, Dreyfus and Prudential-Bache bought commercial banks, and Security Pacific National Bank bought a seat on the New York Stock Exchange. This gave birth to an era where banks entered the securities business while brokerage houses ran a banking business. It all became a bit of a hotchpotch, making it to distinguish one kind of financial institution from another.

The credit card was but the first of a series of innovations in financial instruments that includes the money market account and mutual funds. These innovations have been instrumental in inviting the middle class into the fold of financial services and giving them equal access to financial instruments that has so far been the exclusive domain of the moneyed and propertied class. They enabled to middle class to enjoy a tighter control over their own finances.

If there is anything that we have learnt from the history of American banking it is that investing is absolutely imperative to generating inflation-beating returns and that investor education is the ideal way of helping investors make informed investment decisions. Another important thing that we have learnt is that generally many of the innovative and high-yielding investment products are generally not available to retail investors. However, mutual funds are changing this by pooling investor money and then investing it in instruments that are innovative, spread across different asset classes like equity, debt, and commodities, easy to enter and exit, and managed by experienced professionals. Mutual funds offer several different types of schemes – some could be equity focused, some could be debt focused, some could be commodity focused, and some could also be hybrid. A great example of the latter is a scheme like the Balanced Advantage Fund that invests in a mix of equity and debt instruments and dynamically manages this exposure. Thus, mutual funds give you the option of investing in products that can potentially meet all your requirements, i.e., match your risk profile, return requirements, and investment time period.