YOSEMITE CAPITAL MANAGEMENT

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The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries. – Winston Churchill

Under capitalism man exploits man; under socialism the reverse is true. – Polish Proverb

Capitalism is an economic system where individuals, often organized as corporations, invest in and own the means of production, distribution, and wealth for the purposes of making a profit from mutually beneficial transactions in free and competitive markets. A free market is based on individual rights to own private property, trade freely, and set prices, and depends on a strong legal system based on rule of law to protect those rights.

In a capitalistic system, government exists to protect individual rights and ensure competitive markets, in part by preventing monopolies. Many posit that softening the effects of the boom and bust cycle is an integral part of protecting individual rights and ensuring competitive markets. (There are other aspects of government's role in capitalism that can be extensively debated by reasonable people, but that discussion is beyond the scope of this essay.)

Thus we have the basic textbook definition of capitalism. But there is one more aspect to that system that does not seem to be commonly considered:

Capitalism requires morality to function.

A significant part of this notion is that individual participants must act in a moral and ethical manner. This is what enables both parties to benefit in any given transaction. This concept goes far beyond the bare minimum legal requirements that are necessary but not sufficient.

Capitalism ceases to exist when people act in a selfish manner that benefits only them and hurts others. We saw this big-time in the years leading up to the Credit Bust of 2008:

> People in investment banks sold securities and lied about the underlying mortgages in order to make a deal, essentially swindling the buyers.
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> People in ratings agencies falsely labeled securities with high ratings, often with barely a cursory review, in order to collect a fee, ignoring the negative consequences to the buyers of those securities.
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> People in regulatory departments failed to do their job of responsibly regulating to reign in excesses that could only lead to instability, thus hurting the very people they are charged with protecting.
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> People in commercial banks and other lending companies gave mortgages to applicants without adequately verifying they would likely pay back the money in order to make a commission, which directly hurt the providers of that capital and the borrower and hurt many others indirectly when the entire system practically collapsed.
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> People applying for mortgages lied on their applications about their income in order to get a loan to buy a house or refinance their existing debt to get things they could not otherwise afford, and these actions constitute fraud against the lender and eventually had a ripple effect that hurt many others by contributing to the loss of home equity.
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> People appraising the market value of houses ignored standard practices and colluded with realtors and mortgage lenders to provide the "right" number to get a deal done and collect their fee, and this ultimately hurt the buyer and seller in the transaction.

A few years earlier during the late 1990's and early 2000's, numerous groups of people engaged in behaviors to gain benefits for themselves at the expense of others (much of the harm during this episode was done to shareholders):

> People serving as corporate executives did everything they could to manipulate earnings reports to meet targets, often self-set, in order to make their huge short-term paydays, which deceive and ultimately hurt employees and shareholders from lack of focus on the long term. (In his 1999 Letter to Shareholders, Warren Buffett aptly wrote "as Michael Kinsley has said about Washington: "The scandal isn't in what's done that's *illegal* but rather in what's *legal*."")
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> People on the Boards of Directors looked askance at the actions of executive management, seeming to avoid doing anything that might risk their cushy gigs of high pay and relatively little work instead of fulfilling their duty to work on behalf of shareholders (and keep executive management in check), thus facilitating the abuse of corporate executives on employees and shareholders.

People working as outside auditors of public companies often rubber-stamped the financial reports submitted by executive management instead of doing a thorough examination according to professional standards in order to collect their fees, which ultimately hurt shareholders.

People who worked as Wall Street analysts often acted as cheerleaders for companies, often writing reports that contained misstatements and omissions of material facts in order to get lucrative investment banking deals (mergers and acquisitions, securities underwriting, etc.), an obvious conflict of interest that is detrimental to shareholders. (Perhaps the most famous incident was that of an analyst who changed his opinion on a company supposedly in part to get his children into an exclusive nursery school (http://www.nytimes.com/2002/11/14/business/wall-st-and-the-nursery-school-a-new-york-story.html).)

People who were mutual fund managers engaged in illegal late trading and market timing that benefitted hedge funds and the fund companies themselves, which defrauds long-term holders of the funds (the type of customers for whom mutual funds are designed).

Profit made by hurting others is wrong and is not how capitalism works. None of the actions and inactions in the lists above is an example of free-market capitalism at work. They are lying and cheating and stealing. And given the fact that a great deal of money, time, and effort was made simply to determine whether a particular action was actually illegal or not supports our earlier statement that legality alone is insufficient for the system to function properly.

Incidentally, since capitalism allows one to reap the rewards of taking any (legal) risks, the implication is one must also bear the consequences if things don't work out. But following the Credit Bust in 2008, government and corporate executives of financial companies took care to shield the perpetrators in our aforementioned list from the consequences of their actions. Privatized profits and socialized losses indeed! Clearly this is cronyism and even kleptocracy, not capitalism.

Collectively we broke the economy in 2008 (it's still far from healed seven years later) and caused a stock market meltdown starting in 2000. Both resulted in a severe lack of confidence in the public securities markets, a serious problem in a major developed economy. Yet neither of these episodes had to happen, at least not nearly to the extent they did, if the miscreants involved had stopped for one minute to think about the ethics and morals of their actions or inactions.

Note that in our lists above, all of these actions and inactions were done by people as individuals. As easy as it is to do and as many did, one ultimately cannot blame "the system". And just as an economy grows over time by the grand sum of little everyday actions (and not by commands from on high, whether the executive suite or the political centers), so too must the long term health of the economy – and society – be protected by the grand sum of little everyday implementations of ethics and morals.

Actions done legally are not healthy if they are devoid of morality. Therefore it is up to every one of us to conduct our individual affairs in a manner that collectively contributes positively to capitalism. To do otherwise and act without integrity is to give ammunition to proponents of other economic systems that require a dominant role by government, and this is something that no one who values freedom and the sanctity of individual lives would want.

From top to bottom and across all aspects of business, all of us must ask ourselves some important questions and contemplate on the ramifications of the answers:

What is the culture of the organizations in which we participate?

What is the attitude of the leaders of organizations with which we associate?

How do we get our individual pay and bonuses and profits, by providing value to others or by screwing customers and employees?

How do we treat employees, as valuable assets and partners or costs to be minimized?

How do we pay employees, commensurate with the value of their work or as little as possible?

How do we treat customers and clients, as people we help and serve or simply as meal tickets?

Are we behaving in a manner that serves as a positive role model and leaves a better economic system for the next generation?

Our way of life becomes better when business is built upon a base of morality and ethics, and conducted with personal integrity and respect for each other. That's how capitalism works properly to generate profits for the benefit of all.

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