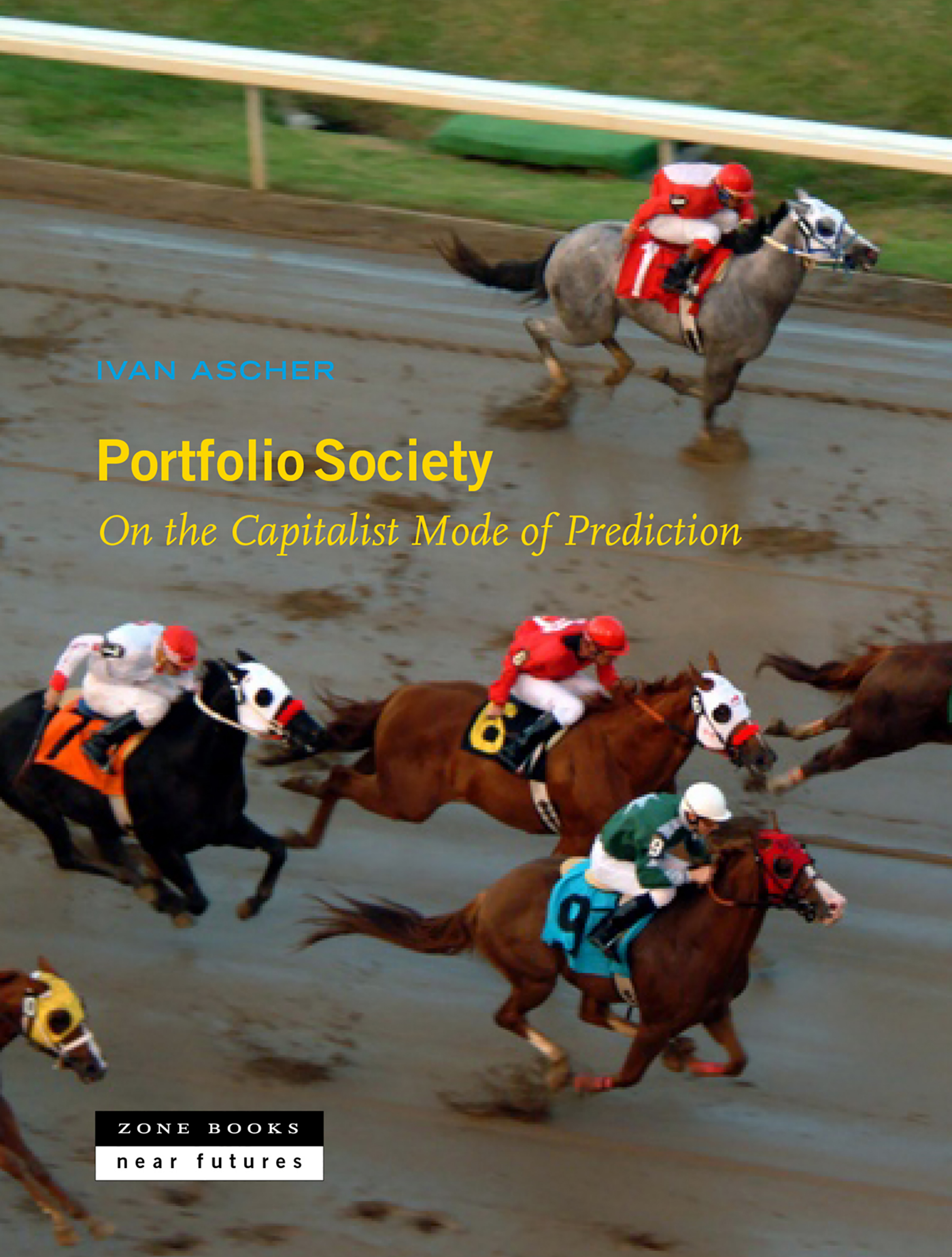
IVAN ASCHER

Portfolio Society

On the Capitalist Mode of Prediction

ZONE BOOKS

near futures



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In memory of François and Bertrand

PREFACE

The Specter of Wall Street

A specter is haunting Europe—and much of the rest of the world, for that matter. Even the holy father, who back in the day had joined the czar, Metternich and Guizot, French Radicals, and German police spies in denouncing the evils of Communism, is now claiming that a "new tyranny" has come into existence—one that is "invisible and often virtual," but nonetheless successful in imposing "its own laws and rules" on all the rest of us.[1] The magazine *Rolling Stone*, meanwhile, is known around the world for its description of Goldman Sachs as a "a great vampire squid wrapped around the face of humanity," and Warren Buffett, the billionaire investor, is likewise celebrated for having described derivatives as "financial weapons of mass destruction."[2] As for the French socialist François Hollande, it was only once he resolutely declared "the world of finance" to be his "true adversary" that he succeeded in his quest for the presidency.[3] All in all, it would appear that the powers of old Europe and those of the New World have finally joined forces against a common enemy, forming a new Holy Alliance to exorcise this magical power that is the specter of Wall Street.[4]

Think about it: what financial crisis has not been blamed on the speculative excesses of Wall Street bankers or the arrogance of the overpaid "quants" among them? What austerity measures, what budget cuts, have not been justified by the demands of the bond markets or the credit rating agencies? And finally, what beleaguered Goldman

Sachs employee has not hurled back the accusations of greed onto the culture of his employer or that of Wall Street more generally?

Two things follow from this fact: first, that Wall Street is "already acknowledged to be itself a Power," as Karl Marx and Friedrich Engels might have put it, and a most frightening one at that; second, and no less importantly, that we must guard against simple denunciations of this genuinely terrifying power—lest we find ourselves disabled before this monster of unspeakable proportions and disciplined even further into submitting to its tyrannical dictates.[5] Indeed, it is high time that we meet our own "nursery tales" of the specter of Wall Street—if not with a manifesto of Wall Street itself (though that would be interesting), then with a proper critique of contemporary finance and the societies that live under its spell.

The present essay is my contribution to such a critique. It is a modest contribution, to be sure, and one that very much bears the stamp of its origins both in the so-called "subprime crisis" of 2007–2008 and in a certain Marxian tradition of critique. The narrative thus begins in January 2007, shortly before a wave of mortgage defaults among U.S. home owners brought about the collapse of the world's credit markets. It ends six and a half years later, with the much-publicized trial in New York City of a single Goldman Sachs employee charged with securities fraud. The analysis, meanwhile, proceeds through a creative appropriation of Karl Marx's *Capital*, volume 1—a seemingly sacred text of social theory that I interpret in a decidedly unorthodox way. My aim in this book, however, is neither to chronicle the financial crisis nor to present a new reading of Marx for its own sake.[6] It is, rather, to begin to theorize twin developments that Marx himself could not have anticipated, but that the crisis has helped reveal: the extraordinary rise of financial markets in recent decades and the concurrent development of what Gerald Davis has aptly called a "portfolio society," in which capitalist relations themselves have to a large extent become "securitized."[7]

As we will see, there is nothing new about financial markets or securitization per se. It has long been possible for investors to acquire shares in the ownership of a company, say, and for these shares to be treated as tradable assets ("securities") to be bought or sold on secondary markets. Likewise, it has been common practice throughout the history of capitalism for cash-strapped governments to issue sovereign bonds to which individuals—including foreign nationals—might then subscribe and which they might alienate in turn.[8] And finally, it has been possible since at least the eighteenth century for investors to bundle together claims to different income streams and to use them as "backing" for the issuance of new, tradable securities. This was done most recently (and most infamously) in the United States with subprime residential mortgages, but already in the 1770s, Swiss bankers were combining life annuities issued by the French state in order to issue safer securities of their own.[9] These are long-standing practices, in other words, that in and of themselves are almost unremarkable.

As we will also see, however, there is much about Anglo-American capitalism that has changed in recent decades, especially since the publication in 1952—by a young graduate student named Harry Markowitz—of the theory of "portfolio selection" to which this book owes its title.[10] Markowitz's argument, in retrospect, was a simple one: rational investors, he claimed, know very well that the future is uncertain and are therefore unlikely to bet all their money on the success of a single company, no matter how promising. Instead, they will tend to invest in a whole panoply of stocks and bonds, attuned as they are to the strategic importance of diversification. Rational investors do not and should not place all their eggs in one basket, in other words, and in selecting their investments, they should not merely consider expected returns; rather, they should attend to what each security contributes to their overall portfolio of assets—and this, in terms of risk as well as return.

A decade or so later, in 1964, it was another graduate student—William Sharpe—who helped turn this theory into practice by introducing a simple coefficient—he called it β—with which to determine a stock's sensitivity to the fluctuations of the overall market. A security with a β greater than 1 was one that would amplify market fluctuations; a security with a β lower than 1 would attenuate them.[11] With this coefficient, Sharpe reasoned, investors could follow Markowitz's advice without having to determine how each potential investment covaried with every other asset in their portfolio. They needed only to consider how the price of a given security moves in relation to the market as a whole and thus construct a properly diversified portfolio that would match their desired level of risk and return.

Though these analyses may have seemed at first like the purely academic musings of precocious graduate students, the principles they outlined—the principles of modern portfolio theory—were quickly internalized by theorists and practitioners alike at a time when markets in general were undergoing significant transformation. Starting in the 1970s, indeed, other intellectual and technological advances—coupled with the demise of the international monetary system that had been established at Bretton Woods in 1944—set the stage for a dramatic expansion in the use of options, futures, and other so-called "derivative contracts."[12] These are contracts that allow investors not only to manage the various new risks associated with globalization (such as exchange rate risk, country risk, and so on), but also to construct and continuously maintain carefully calibrated portfolios that would—in principle—correspond to their chosen levels of risk exposure. As we will see, the development and widespread adoption of the Black-Scholes-Merton model for options pricing succeeded in giving investors the confidence that they could continuously and scientifically hedge what would otherwise have been untenable positions simply by combining the continuous buying and selling of stocks and bonds with the concurrent buying and selling of options and other derivatives. More and more capital flowed to financial markets as a result, and investors—these were institutional investors, increasingly—could now engage in a strategy of incessant trading that allowed them to regulate their risk exposure while simultaneously providing the market with all the liquidity it needed to be plausibly considered efficient, as per the strictures of the newly dominant paradigm.[13]

In sum, by the time Markowitz and Sharpe were finally recognized by the Nobel committee in 1990 for "their pioneering work in the theory of financial economics," the world of global finance had indeed been refashioned along the lines that they had sketched.[14] It was now possible to speak meaningfully of a market portfolio, as per Sharpe's formulation, and risk itself had become a thing that could be quantified and readily exchanged.[15] And by the winter of 2007–2008—the winter of our discontent, when the most recent crisis came into view—it was the entire fabric of society that had been transformed: a third of all profits in the United States were occurring in the financial sector, levels of public and private debt had reached record highs, and access to financial markets—once the privilege of an elite few—had officially become democratized.[16] Commercial banks could now invest with abandon in the world's financial markets (the Glass-Steagall Act of 1933 having just been repealed), an ever greater share of people's retirement savings were being managed by a handful of pension funds (their future, therefore, placed at the mercy of the market's fluctuations), and the U.S. government itself was actively fostering an "ownership society" in which everyone from Wall Street to Main Street would have some skin in the game.[17] Some people were managing billion-dollar hedge funds, while others were merely placing their savings in a retirement account; some were using their home as collateral for a second mortgage, while others were borrowing heavily on behalf of their fellow citizens; but all of them, somehow, were playing the market. Or more precisely, as they would soon find out, some were playing, while others were being played.

The fact of this transformation—the fact, that is, that financial markets now appear as a force of their own while simultaneously mediating an increasing range of social relations—is incontrovertible. But what is the significance of this transformation, one wonders, for our understanding of capitalist relations themselves? More specifically, what are the implications of this transformation for a critique of political economy of the kind inaugurated by Marx a century and a half ago? Marx himself, after all, may have taught us to expect—if not to accept—that the production of goods in capitalist societies would be organized around monetized trade and the pursuit of profit, but what should we make of the fact that even our *promises* are now being made only to be "sold" or otherwise exchanged, as if the mere buying and selling of financial assets were sufficient to turn an uncertain future into a source of security in the present? It seems clear that the very frailty of our social relations—the possibility, say, that we might falter in our commitments to one another—can now be measured and speculated on, but what does it mean to live in a world where *risk itself* can be treated as something to be bought or sold, and is this not to some extent comparable to the ways that labor was once thought of in the European nineteenth century?

Likewise, many readers of Marx have argued over the years that the "free market" is but a liberal fiction—one that allows for workers to be exploited while their employers are free to set the terms of the wage contract. But what is the pertinence of such an insight when in so many places it is the credit relation, rather than the wage, that now appears as the main site of profit-making and political struggle? What are the narratives legitimating these new power relations, and what new forms of violence might we be committing (or suffering) in their name? And finally, even if we assume that some people have always benefitted from the vulnerability of others, whether by speculating on the possible misfortunes in their future or simply by paying them a pittance in exchange for their labor, when and how did such speculation become not only generalized, but seemingly required in order for anyone to imagine a future in the first place? Surely we can concede to Adam Smith that dividing labor has increased its productivity, just as we may concede that the advent of securitization has increased liquidity in financial markets, allowing investors to borrow more capital and thus to multiply the potential return on their investments. But at what cost is such "leverage"—as it is so aptly named—ever achieved, and on whose shoulders exactly? After all, if Archimedes was surely right to imagine that he could move the earth, did he not also acknowledge that he would need a place on which to stand?[18] Who bears the burden of financialization, one wonders, and whose world does it truly lift?

In 1867, some twenty years after the *Manifesto*, Marx prefaced his own critique of political economy with the observation that "beginnings are always difficult in all sciences."[19] And yet, as is well known, Marx nonetheless found a starting point in the study of commodities in exchange—on the assumption, as he put it, that for "bourgeois society" (or "civil society," as it might also be called [*bürgerliche Gesellschaft*]), "the commodity-form of the product of labour or the value-form of the commodity [was] the economic cell form."[20] In light of all that precedes, I propose in the following to proceed from a different starting point, on the assumption that the "economic cell form" of our own portfolio society is no longer the "commodity-form of the product of labour," as in Marx's formulation, but the security form of capital itself.[21]

CHAPTER ONE

Capitalism: A Horror Story

—We're sorry. It's not us. It's the monster. The bank isn't like a man.
—Yes, but the bank is only made of men.
—No, you're wrong there—quite wrong there. The bank is something else than men. It happens that every man in a bank hates what the bank does, and yet the bank does it. The bank is something more than men, I tell you. It's the monster. Men made it, but they can't control it. (John Steinbeck, *The Grapes of Wrath*)

Late one evening in January 2007, on the twenty-sixth floor of Goldman Sachs's headquarters in lower Manhattan, a Frenchman by the name of Fabrice Tourre set out to write an e-mail to his girlfriend back in London, Marine Serres. The young banker—he was only twenty-eight at the time—was a graduate of the prestigious École Centrale in Paris, but had moved to take a much-coveted job at Goldman Sachs in the early 2000s. (In another e-mail to another girlfriend a few days later, Tourre would complain—or boast—that after only six years, he was already considered a "dinosaur" in the business and was expected to serve as a mentor to younger colleagues.[1]) Like many other French bankers working on Wall Street, Tourre was known as a "quant"—that is, an expert in quantitative finance, and had been recruited for his mathematical talents more than for his business savvy or social skills.[2]

More specifically, Tourre's expertise was in the area of structured finance—meaning, in his case, that he was responsible for "structuring" and marketing what were known as synthetic collateralized debt obligations (CDOs)—speculative contracts linked to the performance of subprime residential mortgages.

For several years—roughly since the time Tourre had begun working at Goldman Sachs—the market for synthetic CDOs had grown at a rapid pace. A boom in the American real estate market, coupled with the development of new risk-management techniques and significant changes in the regulatory framework governing the use of so-called "derivative" contracts, had made it possible for lenders to extend residential mortgages (albeit expensive ones) to individuals whose credit history had once branded them as too risky.[3] These subprime loans, as they were called, were then pooled together and sold to investors as duly rated slices or "tranches" (a process known as securitization), which were then pooled together with other tranches and securitized anew. Other investors, meanwhile—with the help of individuals such as Tourre—could then enter into the type of synthetic CDOs just described or the credit default swaps (CDSs) of which they were composed—insurance contracts, of a sort, which allowed them in effect to speculate on the likelihood that subprime borrowers would make good on their mortgage payments.

The system worked. So long as houses kept appreciating and lenders kept finding investors on whom to offload the loans and the risks they carried, it was a win-win situation: home ownership rates grew to unprecedented levels (reaching an all-time high of 69 percent in 2005), giving credence to the government's talk of a new ownership society, and the profits derived from financing these mortgages increased accordingly.[4] Starting in 2006, however, "something ominous began to happen in the United States" as the number of foreclosures in cities such as Cleveland and Detroit suddenly started to rise.[5] By January 2007, over 14 percent of all subprime mortgages in the United States had been delinquent for sixty days.[6] This was a bad sign for the subprime borrowers, to be sure, but it was a bad sign also for all those—and there were many—who had bought exposure to the risks of default associated with such loans. Even the *Financial Times* struck a note of concern when on January 19 it cited various sources (some of them anonymous) describing what they perceived as an unprecedented level of risk exposure in the market. As one of the sources put it, "I don't think there has ever been a time in history when such a large portion of the riskiest credit assets have been owned by such financially weak institutions... with very limited capacity to withstand adverse credit events and market downturns."[7] As for the author of the article, Gillian Tett, she herself evoked the unnerving emergence of a "brave new financial world" and a growing sense of "unease" that was bubbling within it.[8]

The *Financial Times*'s analysis evidently resonated with Tourre, who forwarded the story to Serres with the following recommendation: "Darling you should take a look at this article.... Very insightful.... More and more leverage in the system, the entire structure could collapse at any moment." In an awkward mix of French and English, Tourre went on in a jargon that he knew she would understand (she, too, was a French expatriate, working for Goldman in its London office): "*Seul survivant potentiel* [Only potential survivor], the fabulous Fab (as Mitch would kindly call me, even though there is nothing fabulous abt me, just kindness, altruism and deep love for some gorgeous and super-smart French girl in London), standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all the implications of those monstruosities [*sic*]!!!"[9]

A couple of months passed, but Tourre's concerns did not subside. In an e-mail dated March 7, he told Serres that things were "not looking good for the U.S. subprime business." "According to Sparks [Tourre's superior at Goldman]," he explained, "that business is totally dead,