
VALUE WIZARD INSIGHTER - December 2000

You are receiving this issue of the complimentary newsletter because you visited Global Value Investing with Stock Valuation or requested information about the Value Wizard Investment Models. If your mail reader does not allow you to click on URLs or email addresses, you can simply go to www.numeraire.com (or try to copy and paste the URL into a web browser like MSIE or Netscape). To maintain privacy, your name and email address are included in the Blind Courtesy Copy box with the *Insighter* list suppressed. If you wish to unsubscribe, see the instructions at the bottom.

If this document appears to be misaligned, please set
your mail reader to a fixed-width, non-proportional font
such as Courier 10, or copy and paste the newsletter text
into an editor such as Notepad (Windows users) or vi (UNIX).

In this issue:

----

1. Summum Bonum

We present the perspective of the Big Picture at the Spaceship Earth website with an emphasis on a long-term global perspective, ecological economics and the sociology of science. Different terms, synonymous in different degrees, are used to refer to society's good, including public well-being, public welfare, public happiness, public interest and national interest. One of the earliest of such terms was summum bonum.

Summum bonum (Latin for: the greatest good). The concept, introduced into ethical discourse by Aristotle, of the greatest good that is sought by all men. The Latin phrase was put into currency among moral philosophers by the writings of Cicero. There has, naturally, been considerable disagreement as to what, if anything, may be correctly so called. -- Anthony Flew, editorial consultant, A Dictionary of Philosophy, Revised Second Edition, 1979, St. Martin's Press, New York.

"We have searched into history, and amidst the number of years which its records have laid open to our view, have but too accurately traced the proportion of causes, to effects; and too fully are we convinced, that the people were not only strangers to real happiness, but that they had never taken the road which might have led to it. Our surprise diminished, but our concern increased, when we felt the conviction that the most esteemed governments, and the most revered legislations have never been directed to that sole end of all government, the acquisition of the greatest welfare of the greatest number of individuals. [page 112].

"Now, we have already proved that [science] had not hitherto made the least advances towards that universal end of all philosophy, the acquisition of the greatest welfare of the greatest number of individuals. [page 124].

An Essay on Public Happiness, Investigating the State of Human Nature under Each of Its Particular Appearances, through the Several Periods of History, to the Present Times, Jean Francois, Marquis de Chastellux, 1774, Two Volumes, Reprinted 1969 by Augustus M. Kelley, New York.

Throughout history, demagogues and other politicians have sought to win public opinion over to their campaigns and programs, and the use of an ambiguous, inclusive term such as public well-being enables everyone to believe that the speaker means what each of them privately wants it to mean.

----
2. Allocative Efficiency

"Allocative Efficiency. The traditional economic rationale for the free market is that it allocates scarce resources in the best possible way. ... Henceforth, we refer to the best possible allocation of resources achieved by competitive markets as allocative efficiency or Pareto optimality.

"The Intuitive Argument. The market thus achieves the remarkable result of balancing the marginal costs and benefits of production (or other activities). Where costs are relatively high, activity contracts; where low, activity expands. In either case, society gains. This type of balance, which (as we shall soon see) occurs in perfect competition, is sometimes referred to as marginal cost pricing, or P=MC. Activities are pursued to the point at which their market price, a reflection of marginal benefit, is just equated with the marginal cost of the resources used up by the activity.

"Perfect Competition. The intuitive argument above assumes implicitly some characteristics of markets that must now be made explicit. These conditions define perfect competition:

1. Many small firms such that no one firm can have a perceptible impact on total market supply;
2. A homogeneous, or perfectly substitutable, product.
3. Easy entry and exit of firms; and

4. Perfectly informed buyers and sellers.

"The Meaning of Social Choice: Efficiency versus Equity. Society, however, cares also about other things--for example, equity, fairness, or justice. Social as opposed to individual choice involves comparing and ranking different economic states of the world for a group--the community or the whole society.

"Human Rationality. The market may be thought of as a mechanism for translating the interests of rational human beings into social decisions. ... Even at this very basic level, however complications arise. The word rational can have several meanings.

"Introducing Equity or Justice. Social as opposed to individual choice involves comparing and ranking different economic states of the world for a group--the community or the whole society. ... One approach is to suggest that what is good for society--the social good--can be defined by somehow combining or aggregating individual preferences. ... The point is that when the social good is defined as the sum of individual satisfactions, the distribution of welfare among the members of society is in itself of no significance. ... [P]roved that under certain mild conditions it is impossible to derive a social welfare function from individual preference rankings. ... When weight is given to what individuals in a society want, conflict seems inevitable.

"Rights. Another approach to the problem of defining economic justice is to shift the focus toward a consideration of individuals' rights rather than toward their relative standard of living.

"Some Qualifications. The allocative efficiency case for the competitive market is logically unassailable. The implications of this argument for social decision making, however, must be treated cautiously, and we have already noted the first reason for caution. Markets may be efficient but people care also about fairness. The market, if it functions well, may satisfy the marginal Pareto conditions, but the particular results that emerge will depend also on the distribution of income and wealth (that is, spending power) in society. ... The values that we place on things via the market are defined not only by our individual preferences, but also by our ability to pay for them. ... The Pareto criterion has little to say about this issue. One may, then, be aware of the virtues of Pareto efficiency, yet also believe that income and wealth are distributed incorrectly (unfairly).

"The Impossibility of Perfect Competition. Given that perfect competition is the ideal allocator of resources, how important is this in an imperfect world? What is the significance of an ideal that is seldom, if ever, attained?

"Externalities. The argument for competitive efficiency presupposes that there is no divergence between private and social valuations. The marginal utilities (or benefits) that consumers see coincide with society's benefits, and producers' marginal costs are identical to those of society. However, divergences--which are usually called externalities--are quite common.

"Internal ("X") Efficiency. A distinctive virtue of properly functioning markets is that they force firms to be internally efficient in a number of ways. Such X efficiency amounts to a rather strict cost-minimization condition.

"Noneconomic Virtues of the Marketplace. ... The Impersonality of the Market. ... The Democracy of the Market. ... Process versus Results. The economic value of any activity is defined by the willingness of consumers to pay for it. ... The Market and Human Happiness. [W]hether market optimization and human happiness coincide, or even have much to do with each other. Market advocates contend that economic efficiency creates greater welfare or well-being (the terms are notoriously difficult to define). Sometimes the contention is modified as follows: efficiency permits possible welfare gains, without a corresponding possibility of losses.

"Summary. The economic virtues of the marketplace are strong indeed. Free markets organize literally millions of activities in a relatively efficient manner. Under the strict conditions of perfect competition, we could even expect to achieve optimal efficiency in the Pareto sense of the term. Furthermore, markets have some important noneconomic characteristics that are highly appealing in a democratic society. Is there also a negative side to the market system? Of course, as we shall see [Market Failure: Monopoly; Oligopoly; Public Goods, Externalities, and Information Problems].

"Conclusion. We have seen that a strong case can be made for the market as a reconciler of private and societal interests. It takes the selfish motives of individual buyers and sellers and channels them into socially optimal economic decisions. [Footnote: Some people find it surprising, perhaps even distressing, that society's well-being in a market economy depends upon individual greed. The word "greed," however, is heavily loaded with negative connotations. One might instead point out that markets facilitate an enlightened self-interest, such that one can pursue one's own goals only by doing socially valuable work.

"Appendix 2A. The Optimality of Perfect Competition. [A] system of perfectly competitive markets will automatically satisfy the marginal conditions for a Pareto optimum, a fundamental concept in welfare economics. Consider first the meaning of an improvement in society's well-being. This is potentially a complicated matter that we will discuss shortly, but let us begin with Pareto's definition: an improvement is any change that helps some member(s) of society and harms no one. At least superficially, this is a noncontroversial definition. When some people are better off and no one is worse off, the welfare of the group as a whole--the society--has improved. [Footnote: The criterion may seem reasonable, but it should not be taken as an objective or scientific statement. The Pareto notion of a social welfare improvement does rest on a value judgment, as we shall see.]

"The Pareto optimum may then be defined as that state of affairs in which no further (Pareto) improvements are possible--a situation such that the welfare of some member(s) of society can be improved only by harming the welfare of some other member(s). All the costless improvements--those that hurt no on--have already been made. ...

"When all three conditions hold, our simple economy is at a Pareto optimum. No change in the distribution of goods among consumers, the allocation of inputs to productive uses, or the amounts of goods produced can help one of our consumers without substantially hurting the welfare of the other.

"We therefore conclude that a system of perfectly competitive markets implies Pareto optimality."

Government and the Marketplace, Second Edition, Peter Asch and Rosalind S. Seneca, 1989, The Dryden Press, Chicago, Chapter 2 The Virtues of the Marketplace, pp. 40 and 42, and Appendix 2A The Optimality of Perfect Competition, pp. 46-49.

Commentary: The issue here is social or distributive justice, as opposed to individual justice. In welfare economics, all individuals are considered equal as consumers, so that whether the wealthiest person or the least wealthy person receives a unit of production to consume, it is treated as equivalent for society. In addition, social welfare applies to all of humanity, including the unborn, and any group less inclusive is an arbitrary constraint on the Pareto optimum.

----

3. Capital Markets

Capital markets are markets for financial assets (claims on stuff) in contrast to markets for goods (stuff). Capital markets also generate market-related data or information for which there is a market. Capital markets allocate financial risk-bearing as well as the results of risk-taking. The allocative efficiency of capital markets is increased with a higher degree of transparency in the price formation process, lower transaction costs, and more fully informed participants none of which has the ability alone to influence prices.

Kenneth Arrow has written extensively about the allocative efficiency of capital markets. The following citations are some of his works.

Economic welfare and the allocation of resources for invention. In The rate and direction of inventive activity: Economic and social factors, 609-625. Princeton: Princeton University Press (for National Bureau of Economic Research), 1962.

The role of securities in the optimal allocation of risk-bearing, Review of Economic Studies 31: 91-96, 1964.

Aspects of the theory of risk-bearing. Helsinki: Yrjo Jahnssonin Saatio, 1965.

Alternative approaches to the theory of choice in risk-taking situation. In Essays in the theory of risk bearing, ed. K. J. Arrow, 1-43. Chicago: Markham, 1971.

----

4. Winter Solstice

Our longest-staying and repeat visitors come from scores of nations around the globe. They come mainly from Internet service providers, academia (universities, colleges and school systems) and the financial services industry (investment banks, brokerage firms, commercial banks, trust companies, insurance companies, investment companies, investment advisors, major audit/accounting firms, financial planners, and law firms). They also come from companies (financial consulting, financial modeling, diverse industries, headquartered in different nations), organizations (agencies, research, not-for-profit), governments and governmental agencies (international, national, state, local and public libraries) and the military. We seem to be reaching our intended audience of intelligent investors, security analysts, finance instructors and students all over the world.

Winter solstice for 2000 will occur at 5:37 am PST on December 21. If you want to be precise about it, please be sure to correct for your time zone. Thursday, 21 December 2000, is the shortest day of the year in terms of daylight time. It marks the turning point on the sun's ecliptic when it is farthest south of the equator. From this shortest day called the winter solstice marking the solar cycle birth to the longest day, called the summer solstice, days will get "longer" or sunnier. People in different cultures from around the world may celebrate different holidays during this season, but this astronomical day is one we all have in common.

Have a Wonderful Winter Solstice !

Peace on Earth
Joy to the World
Goodwill to All

To Unsubscribe, Ask Questions or Provide Feedback

If you would like to unsubscribe:

If you used the ListBot to subscribe, then you may use it again to unsubscribe yourself. Use your same address. Nothing else is required.

If you did not use the ListBot:
1. Please do NOT REPLY to the newsletter email address -- your mailing list email address is suppressed for privacy and cannot be identified.
2. Send an email to insighterlist@numeraire.com and include your mailing list email address.
3. Either change the subject line to "Unsubscribe", or include the word "unsubscribe" in the message.
4. Please note: You will NOT receive an email confirmation regarding your unsubscribe request unless you request one.

To provide feedback about the Value Wizard Insighter newsletter:
Please send all questions and comments directly to the online editor.
editor@numeraire.com

We appreciate your feedback!

The Value Wizard Insighter emailing list is managed and used exclusively by Numeraire. Numeraire does not sell, rent or provide information about its subscribers to any third party.

END