Essay written by Peter Rieder, BA, BA, BEc.

20 January 2015

ECONOMICS

Riederwirtschaftswissen

A strategy for economic strength and stability

Riederwirtschaftswissen provides a foundation for economic strength and wealth. Mittelstand corporations are vital for stable economic growth. The corporations create high quality goods and services. Managers pursue a long term strategy of corporate profitability. Public corporations appease shareholders and short term corporate objectives. Private banking contributes to wealth. Hedge funds undermine and often destroy wealth. Educational focus on natural sciences, engineering and humanities creates productive and innovative executives and employees. Business education fails to create successful corporate leaders and entrepreneurs. The influence of financial institutions exceeds their economic contribution. Classical economic theory is problematic and flawed. It undermines long term economic growth and wealth.

Mittelstand corporations dominate the corporate environment of Austria, Germany and Switzerland. Mittelstand refers to the middle estate between the aristocracy and peasantry. The corporations emerged in the Austrian empire during the medieval period. The Austrian empire incorporated Austria, most of contemporary Germany and Eastern Europe. The free bourgeoisie of Vienna, Salzburg, Innsbruck, Linz, Graz, Hamburg and Frankfurt created small and medium size businesses. Their education and skills resulted in the creation of impeccable goods and services. High quality goods and services demand high prices. Corporate customers are willing to purchase goods and services at high prices. Family ownership and management provide the foundation for achieving long term corporate objectives of revenue and profitability. Trodat GmbH is an Austrian Mittelstand company located in the Upper Austrian city of Wels. The company is the global leader in self-marking stamps, engraving, marking and laser cutting. It generated revenue of €145.7 million in 2012.

Public corporations are concerned with short term strategy and appeasing investors. Executives pursue short term objectives of revenue and profit to satisfy institutional investors. Managers often neglect investing in new technology or products and services. It undermines long term revenue and profit objectives. Executive politics can disrupt or adversely affect the pursuit of long term corporate objectives. The tenure of executives governing public corporations is much shorter compared to private corporations. The tenure of CEOs at S and P 500 corporations in the United States in 2012 and 2013 was 7.2 years according to executive recruitment firm Spencer Stuart.

Dominant corporations exhibiting monopoly authority create economic success and prosperity. Economic theory suggests a monopoly is inefficient. A firm dominating a market with the ability to control price and quantity of goods or services offered to consumers are able to earn maximum profit and prevent competitors entering the market. Earning maximum profit contributes to economic wealth. The corporation can invest in research and development to maintain its dominance. Monopoly is rare. A few dominant corporations exert tremendous authority in most markets while most competitors are much smaller. Perfect competition is another rare economic concept. A large number of corporations create homogeneous products and or services. Price competition governs the market and every corporation is concerned with survival. There is no managerial incentive to finance research and development or invest in employees. Perfect competition fails to contribute to economic growth and wealth.

Highly skilled managers and employees are necessary for an enterprise to flourish. A variety of skills and expertise are required for a corporation to operate effectively, create excellent goods and services and achieve corporate objectives of revenue and profitability. The physical sciences, engineering and humanities are the disciplines providing the impetus for corporate innovation, research and development. Dr Georg Jungwirth, a professor from Graz examined 190 Austrian Hidden Champions corporations. He discovered innovation, technology and product quality were the three most important factors contributing to the success of Hidden Champions. Hidden Champions employ engineering, computer science, chemistry, physics and humanities graduates to create corporate success.

Private banking is an important factor contributing to wealth. Private banking provides wealthy clients bespoke service and advice. Services encompass accepting deposits, discretionary asset management, brokerage, limited taxation advisory and basic concierge services. Venetian banks developed private banking by managing personal finance for wealthy families. Private banking flourished in Austria, Germany, Switzerland, Liechtenstein and Luxembourg. Smaller private banks in Austria, Switzerland, Germany, Liechtenstein and Luxembourg manage wealth for exclusive clients. Bankhaus Spängler in Salzburg, Bank Gutmann in Vienna, Bankhaus Metzler in Frankfurt and Bankhaus Lampe in Bielefeld are four examples of smaller private banks providing bespoke service to wealthy clients since the 1800s. Larger financial institutions do not provide bespoke service to wealthy clients. The institutions use their size and brand to attract wealthy clients, but cannot compete with the exquisite service provided by smaller private banks.

Free trade is flawed and unsustainable in the long term. The principle of comparative advantage claims countries pursue international trade to exchange goods and services each country produces efficiently. Efficiency implies producing goods and services at the lowest cost. It does not consider the skill, talent and expertise required to produce goods and services. Lower costs tend to yield poorly created goods and services. The large number of bilateral trade agreements since the 1990s suggests free trade is ineffective. Countries introduce trade barriers to protect the production of goods and services against cheaper rivals. Protecting impeccable goods and services deserves admiration.

Hedge funds destroy investor wealth and enrich hedge fund managers. A hedge fund is an investment vehicle utilising funds from wealthy investors. Professional managers govern the fund with the objective of achieving a positive return on investment irrespective of market conditions. Hedge funds typically charge clients two percent for managing assets and twenty percent for generating profit. Hedge funds cultivate a façade of extraordinary performance. The mystique conceals the reality most hedge funds fail to perform. It is very difficult to predict fluctuations in any market and generate income and profit. Simon Lack, a former investment banker published *The Hedge Fund Mirage* in 2011. His research revealed the Global Hedge Fund Index generated annual returns of 2.1 percent between 1998 and 2010 using a money weighted basis. He estimated hedge fund managers earned US$379 billion and investors earned US$70 billion profit between 1998 and 2010. Lack estimated investors lost US$308 billion from hedge funds while the hedge fund industry generated fees of US$324 billion between 1998 and 2010.

Many hedge funds utilise inside information to devise strategy. The use of inside information undermines the claim hedge funds employ the finest business school graduates with the ability to predict investment opportunities and create considerable profit for investors. SAC Capital Advisors was the epitome of New York hedge fund success. It was profitable since its establishment with US$25 million in 1992. The firm managed US$15 billion in assets in July 2013. In March 2013, the firm agreed to pay the Securities and Exchange Commission (SEC) US$616 million to settle civil charges for insider trading. The firm became a family office.

Business education fails to create entrepreneurs and corporate leaders. The Master of Business Administration degree is portrayed as a necessary qualification to govern a large public corporation or financial institution. The qualification is a worthless document. Graduates are taught the basics of finance, accounting, marketing and economics. The degree provides an opportunity for graduates to develop professional networks. Students are not taught the complex nature of leadership, strategy and managing employees. Graduates are ill-equipped to become corporate leaders and entrepreneurs. Most business school graduates use the Master of Business Administration degree to ascend the corporate hierarchy at a financial institution or begin a career in finance. Henry Mintzberg, a respected management academic wrote an article for *Fortune* magazine in 2004. The article examined *Inside the Harvard Business School* published in 1990. The book contained a list of nineteen Harvard Business School graduates described as great executives. Mintzberg assessed the performance of the graduates between 1990 and 2003. He discovered ten graduates failed in the role of corporate executive and four were questionable.

Capital markets encourage speculation and enrich institutional investors. Capital markets encompass securities and derivatives. Investors can purchase securities in a public company and become shareholders. Investors purchase derivative contracts to minimise risk and or speculate and profit from market fluctuations. Institutional investors dominate capital markets. Institutional investors manage large sums of investment capital. Investment banks, insurance corporations, hedge funds, pension funds, mutual funds and investment advisers are the primary institutional investors. The tremendous size of institutional investors influences investment and the direction of capital markets. Institutional investors generate significant revenue and profit from investing in securities and derivatives. Smaller investors have no influence. Small investors are at the mercy of larger rivals. Global equity market capitalisation was US$64.195 trillion in 2013. The value of equity trading was US$55 trillion in 2013. 19.5 billion derivatives contracts were traded in 2013.

Government bonds provide an opportunity to invest in projects neglected by private corporations. Government bonds are issued to institutional investors. A sovereign government promises regular interest payments and repay the face value of the bond at maturity. Governments issued government bonds to finance wars, construct infrastructure and finance public goods. Austrian Empress Maria Theresia established the Wiener Börse in 1771 to issue imperial bonds to finance infrastructure projects throughout the vast empire.

The influence of financial institutions exceeds their contribution to economic value. Financial institutions provide the role of a financial intermediary. A financial intermediary transfers funds from savers to borrowers. Surplus funds are available for borrowers. It is a vital role for financing investment. Investment banks, hedge funds and private equity firms are concerned with corporate finance and institutional investment. Capital market expansion during the last four decades provided the impetus for those institutions to exert greater economic, financial, regulatory and political influence. Global financial institutions managed assets valued at US$146 trillion in 2013. Financial institutions have been larger than the global economy for more than four decades. It contributed to financial instability culminating in the 2008 international economic and financial crisis.

Banks should be smaller and concentrate on the role of lending rather than investment banking and stockbroking. Banks expanded their services and the value of assets under management since the 1970s. During the 1970s banks became public companies and the demand to satisfy short term shareholder objectives of increasing revenue and profitability compelled banks to expand primarily through acquiring stockbroking firms, small private banks, boutique financial advisers and rivals. Larger banks and financial institutions threatened bank stability. Smaller banks do not please investors. However, smaller banks are less likely to threaten a country's entire financial system and economy. *The Banker* published its annual Top 1000 World Banks in June 2014. The top 1000 banks generated US$920 billion profit in 2013. The global banking industry managed assets worth US$116 trillion in 2013 according to the Bank of England. The global banking industry is considerably larger than global gross domestic product. Global gross domestic product was approximately US$87 trillion in 2013.

Classical economics is a deeply flawed economic school. It provides the foundation for much of the economic theory taught at universities and influences government policy. The invisible hand also known as the price mechanism is the central principle. Market forces of demand and supply interact to determine equilibrium price and quantity. The idea fails to recognise market equilibrium does not necessarily result in the most desirable outcome for producers or consumers. The price mechanism cannot prevent market failure, negative externalities, incomplete markets, monopoly power, unstable markets and information failure. Greater government regulation will not resolve the matter. Economists and corporate executives have to abandon the obsession with market forces.

Natural resources created in a laboratory will replace exploitation of natural resources. The intellectual property rights for artificially created natural resources will become extraordinarily lucrative. Investment in mining projects will decline as the cost of finance will become expensive. Revenue and profit will become unattractive to corporations and investors. Scientists at Johannes Kepler Universität Linz in Linz, Austria artificially created photosynthesis in 2014. The chlorophyll substitute created at the university is more stable than plant and algae chlorophyll. Energy loss from the chlorophyll substitute is less than the photosystem found in green plants. Scientific research will propel substitutes for other natural resources, particularly finite natural resources.

Riederwirtschaftswissen examines the factors contributing to economic strength and stability. Mittelstand corporations are essential for generating economic growth and wealth. Most of the corporations are privately owned and concentrate on producing high quality goods and services for corporate clients. Public corporations are dedicated to satisfying investor desire for short term profitability. Private banking is concerned with preserving wealth. Hedge funds tend to destroy investor wealth. Business school education fails to provide graduates with the knowledge and skills to become corporate leaders. Innovative corporations recruit university graduates from natural sciences and engineering disciplines. Investing in substitutes for natural resources will yield lucrative profits from intellectual property.