We had a bear market. We still may be in a bear market. We will have bear market rallies. We will have pullbacks. Buy on the pullbacks. The market will definitely be up in a few years. Thats all we all know. Everyone. From Warren Buffet on down. No one knows more. No one knows less. And thats a problem.

The reality is that when it comes to the risks of the market, we have learned absolutely nothing from the past 2 years. Just as we learned absolutely nothing from the tech bubble and the calamities of markets past.

So I ask you. What is it about the stock market and those who dominate the money flows in and out of the market that has changed ? Will people be any less interested in making money ? Will mutual fund or hedge fund managers desire to make less money than they did 3 years ago ?

It all comes down to this. What will cause anyone on Wall Street to take fewer risks in the market going forward than they did before ? Might they not take greater risks as they try to recapture their losses from the last couple years ? I guess you could argue that leverage to the biggest risk takers of the past 5 years is less available today than it was before, but for how long ? As liquidity becomes more available, why wouldn't financial engineers find every way possible to use it in the market ?

Maybe I missed it, but has there been any structural, regulatory or systemic changes in the stock market that can prevent what we just went through from happening again ? Quickly ?

Nothing has changed over the past couple years. Its all going to happen again. Which is exactly what Wall Street wants. The market is up 36pct in 2 months. Everyone is making money again.

Until they aren't. So what should we do ? I will repeat what I wrote last October:

The Cause of Bubbles =Investment vs Financial Engineering

Oct 11th 2008 3:12PM

Let me get this straight. In **2008**, funds trying to squeeze out another basis point or two thought they were being conservative **buying insurance** on heavily leveraged portfolios of sub prime loans and other debt. Once those loans started to default, it created a cascading deleveraging event which lead to major financial institutions failing and the "smartest" minds on Wall Street being forced to dump everything to raise cash, which in turn lead to a crisis of confidence and deleveraging that created the worst week in the history of the stock markets. Did I get this right ?

In 1987, funds, trying to squeeze out another basis point or two thought they were being conservative, **buying insurance** on leveraged stock portfolios. Once the stock prices on those portfolios started to drop, their insurance programs pushed them to dump everything AND sell stock index futures to raise cash, which in turn lead to a crisis of confidence and deleveraging that created the worst single day melt down in the history of the stock markets. Did I get this right ?

Think it wont happen again ? Of course it will. Whatever money the Fed makes available to stimulate the economy will be used, as intended, by entrepreneurs and businesspeople to create and grow businesses.

Unfortunately, it will also be used by financial engineers to try to find a way to make HUGE profits from highly leveraged,risk laden financial packaging. Why wouldnt they ?

If you can borrow cheap money , invest in some asset that can be marked to an increasing market, borrow against the gain and buy something else and do it as many times as possible, wouldnt you ? Its exactly how homeowners In a bull market drove up real estate prices with a few making huge money.

If you could do the same thing, but instead of with houses, with stocks or asset backed securities, and instead of with thousands, do it with billions so you could profits in the 10s of millions or more, wouldnt you ?

Hell yes you would. You certaintly arent going to tell yourself that you could be creating the next big bubble that could rival 1929, or for future generations, would rival 2008, so dont do it. You would go for the money.

Which is the genesis of our problem in the US. Its not wrong to run with bull markets and leverage to the hilt. That can be a very good thing. But we have to make the upside based on investments, rather than financial engineering. Which is exactly why we have to change our tax code. We want to encourage investment, not financial engineering.

The financial markets were originally defined as markets that created capital for businesses to start and grow.

Today, that is rarely the case. Sure companies do come to the markets for cash for growth and that should be encouraged. But those examples are a tiny percentage of the market. When a stock turns over its float multiple times in a day, those are not investors buying and selling the stock. Those are traders or financial engineers.

The ONLY WAY WE ARE GOING TO END THIS BOOM AND BUST CYCLE IS IF WE DIFFERENTIATE BETWEEN INVESTORS AND EVERYONE ELSE.

Investors should be rewarded for actually owning companies and gaining returns on their investments. Financial engineers should have to pay a premium for the risk they introduce to the entire financial system. It was not investors that brought on the last 2 crashes. It was the financial engineers.

The beautiful thing about this country is that we like to work hard, and we like to take chances. Unfortunately, over the last 15 years, the incentives have been to take chances as a financial engineer rather than as an entrepreneur. We give far more money to people who play games with financial instruments than we give to people who come up with ideas for the next big thing. That needs to change if we want to remain a leader in this world.

Here is what I would do to change things

I would change to zero the taxes on any gains from the sale of stock or bonds purchased during an IPO and held for 5 or more years. All dividends/interest paid by that stock/bond would be tax free. If you sell it prior to the 5 years, you are taxed at your personal regular income tax rate.

In addition, I would not allow the stock to be borrowed against in any way. If it was, it would be considered an effective sale. Which means you couldnt borrow on it tax free until you have held it 5 years. Bottom line, if you hold the stock/bond , like a real investor would, you are rewarded for it.

For purchases post IPO, in the open market, the same rules apply, except I would tax a personal income rates the dividends/interest for the first 5 years of ownership.

For all other transactions, whether they are options, derivatives, stocks, bonds, whatever, all gains and losses would be taxed at personal income rates.

If you are a great financial engineer and make tons of money at what you are doing, more power to you.If you are good at what you do, you pay more to Uncle Sam, but you still make a boatload of money.