INVESTMENT BANKING

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PREFACE

This book has been written to set forth the principles and practices of investment banking. No systematic exposition of this subject has heretofore been made in book form. Both among bankers and banking teachers the need for a general treatise has long been felt. It is hoped that the volume will supply to the investment banking community for use in its own instructional work, as well as to the college teacher of banking, a comprehensive and usable statement of the economic basis, the policies and the methods characteristic of this fast-developing branch of banking.

During the past few years, the teaching of banking has undergone a complete transformation. Not only has the number of courses offered in academic institutions, as well as the degree of their specialization, been largely increased, but there has been a decided alteration of content as well as a considerable change of method.

The older instruction in banking (so-called), in which predominant emphasis was placed upon the legislative and public aspects of the subject, and in which major attention was given to doctrinal points, has been largely superseded. This has not implied any reduction in the importance assigned to the earlier view of the subject, but has been the result of the great extension of the borders of the study. As in most branches of scientific inquiry, advance in knowledge has produced a lessening of assurance or positiveness in dogmatic instruction, and has tended to defer the presentation of theory until the later stages of the student's work. Discussion of policies applicable to the legislative treatment of banking, and analysis of prices and price movements are logically recognized as best presented to those who have already become acquainted with banking technique and procedure, at least in outline.

Such a change, wherein first attention is given to fact-study and to an understanding of procedure, would naturally broaden the general scope of the material presented to the student. "Banking" unavoidably becomes much more than the analysis or description of the actual procedure of the commercial bank. It is seen as closely connected with other fields of economic thought, a basic analysis of "financial civilization," and hence as a study which must orient itself in the general scheme of economic science. The result has been to broaden the field of what is called "banking" so as to include all phases of the process generically thus designated; while at the same time the increasing attention of the commercial world to long-term financing and the security markets has helped considerably to supply a more adequate and inclusive body of data. Current business tendencies and changes have called for larger recognition of certain types of banking procedure, at the same time that scientific reconsideration of material already available has pointed to new syntheses of banking data.

Among the specific fields indicated by these parallel factors of thought and experience as calling for separate description is investment banking. The field covered by, or included in, this subject comprises some topics formerly sporadically dealt with under such heads as Stock Exchange Speculation, Corporation Finance, Investment Analysis, and the like. It does not in any sense duplicate these older fields, or even include a principal part of the areas covered by them. Like the subject of banking in its commercial aspect, which naturally presupposes some knowledge of accounting, business law, and general economic principle, investment banking makes use of previous studies in the field of speculation and stock market organization, of commercial law, of corporation finance and of banking itself. It is a synthetic treatment of material which, although always available, has not until lately been afforded combined presentation.

The authors firmly believe, furthermore, that more intensive study of investment banking will necessarily occur in courses now devoted to the general field of investment, as well as in the banking curriculum. In the teaching of banking, it has become common to stress the description of banking institutions, far more than the instruments of banking, such as notes, checks, etc. In the teaching of investment, on the contrary, almost exclusive attention has been devoted to the instruments —various types of stocks and bonds—and altogether too little to the institutions by which they are evolved and sold. This volume aims to fill this gap, which is a real one since a growing number of students plan to enter the field of investment banking in one or another of its manifold phases. Their needs are not met by a cursory review of the more obvious characteristics of different classes of securities from the viewpoint of the investor.

Teachers of investment banking, like the early teachers of banking in the older sense of the word, have had to encounter serious obstacles growing out of the fact that their material was scattered, fugitive, and hard to present in compact form. There are many valuable books dealing with investment, accounting analysis, corporation finance, and with the specialized investment banking institutions such as trust companies, investment trusts and insurance companies. There are few in which the effort is definitely made to outline the general processes of investment banking which underlie all these institutions, and which condition their activity. In presenting the subject to classes, especially where such classes are too large to permit much detailed work in the library-laboratory, and especially in presenting it to students in the smaller institutions of the country where available current financial sources of information are fewer, the teacher has had to overcome increased difficulty.

This volume is the outgrowth of experience at two universities in which the subject is followed by classes often of considerable size. In presenting investment banking to such classes during past years, it has been found needful to accumulate extensive notes for distribution to students, and to proceed largely by the assignment of library readings; in the absence of a general text covering the entire ground. Within the past two or three years, the question of consolidating portions of this material and giving it a more formal and available shape has been under advisement, and the book as now published is the result. It is intended as a handbook for the use of students of investment banking.

In dealing with the subject, the authors have thought best to make the volume primarily descriptive and to reduce the discussion of theory to the smallest limits possible, while eliminating matter that was in any definite way controversial. Discussion of most of the fundamental problems of theory is thus left for the instructor and his students, the handbook providing merely a convenient basis for the descriptive outlining of the field, with a few essential theoretic discussions. The data presented are chiefly well-known, though it is thought that in some chapters it has been possible to furnish more nearly current accounts of methods and technique than are easily available elsewhere. In preparing the chapters which relate to current practice, special care has been taken to "check over" the pages on these topics with practical investment bankers, and to compare them with recent or current discussions. Valuable criticisms were received from Dr. Marcus Nadler of New York University, who read the entire manuscript. Dr. William Howard Steiner contributed interesting material to one of the chapters. While there has been an equal division of work between the authors, they have collaborated at all points, and are jointly responsible for statements made and views expressed.

With the purposes thus set forth, and the circumstances outlined, the volume is presented to the public.

New York,
October, 1929

H. Parker Willis
Jules I. Bogen

Part One

Investment Banking Institutions

Chapter I

INVESTMENT BANKING—CONCEPT AND INSTITUTIONS

Scope of Investment Banking

The term investment banking has come into general use only within recent years. It is now employed to designate a distinct phase or department of banking. The old generic term of banking has, on the one hand, been broadened considerably to permit this inclusion, and, on the other hand, the concept has been more sharply limited and defined through division into the two departments of commercial and investment banking.

By banking in the most general sense is meant the business of receiving, conserving and utilizing the funds of the community, or of any special section of it. A bank is an institution which devotes itself to this particular class of business operations.

In its most primitive form, the bank merely receives and safeguards the funds of the individual. In earlier days, this type of banking was best illustrated by the operations of the goldsmith bankers of England, who in the seventeenth century were the chief custodians of the public's money in that country. In our own time, this type of banking is still carried on by safe deposit companies, which are formed by banks to rent space in safe-keeping vaults to individuals and corporations.

A step forward in the evolution of banking occurred when the bankers lent out at interest the funds which they received from the public. This added a vital feature to the banking process—the study and analysis of credit for the purpose of assuring the safety of the loan. The Lombard bankers in Italy and the German bankers in the Rhine cities carried on lending operations, with both their own money and that of depositors, even in the Middle Ages. The bank thus became an intermediary between the owners of capital who cannot use it productively and those who wish to utilize this capital in one form or another.

A final step in the evolution of commercial banking was the issue by the bank of its own obligations in the form of notes or deposit credits, while the bank retained from its own funds and those of depositors merely enough actual cash to assure its ability to meet such obligations on demand. Instead of merely handling the existing media of exchange, the bank thus creates such media. Instead of acting merely as an intermediary between those who are in possession of cash and those who wish to borrow it, the bank permits those who are in possession of any form of property or wealth to gain possession of buying power in the form of bank credit. With this property as the basis, the bank makes loans which give current purchasing power to the borrower.

In the course of this evolution of technique, however, there has been evolved a separate type of banking activity which only in recent years has developed into a distinct division of the credit system with a recognized individuality. Efforts to determine which type of banking first appeared in history would be fruitless, for some of the most primitive banking operations recorded even in ancient times smack of both. Suffice it to say that investment banking has followed a line of development somewhat parallel to commercial banking. In its more primitive form, investment banking involved a loan of the capital of the investment banker, or that of a few clients, on a long-term basis to some sovereign. Such loans were common in Europe in the later Middle Ages and after, and were often represented by long-term securities. Now, however, the investment banker buys the stocks and bonds of governments and corporations which desire capital, after he has made some analysis of the credit risk corresponding to the study of credit made by the commercial banker, and then he resells these obligations to others. Up to this point, the investment banker is like the commercial banker who relends only funds which are deposited with him. In special fields of investment banking, however, a third step has also been taken, where the investment institution sells its own obligations to investors, advancing the proceeds to those who can utilize the capital. The mortgage bank is an example of such an institution.

Functional Distinction between Commercial and Investment Banking

General usage would hardly sanction any single clear-cut and definite distinction between commercial and investment banking. Perhaps the factor which is most frequently used in making rough practical distinctions between the two is that of time—commercial banking involving short-term advances to borrowers, while investment banking involves long-term advances which generally take the form of negotiable securities. But, as will be seen below, other factors, such as the purpose of the loan, the character of the institution making it, etc., are also frequently to be considered in making this distinction.

Although there is no intrinsic reason why this must necessarily be the case, commercial banking institutions operate in the main through the system of deposit and discount, while investment banking is carried on through the purchase of security issues and their subsequent sale, at a profit, to investors. Exceptions may be noted. Commercial paper may be bought and sold like securities, and commercial banks, after making short-term loans, may rediscount such paper with a Federal Reserve Bank. On the other hand, the savings bank receives deposits in much the same way as commercial banks, but uses the proceeds to buy securities in the capital market. Furthermore, investment houses have been known to keep short-term securities purchased from issuing governments and corporations until their maturity, instead of selling them to others. Hence, from the point of view of method of operation, only rough and approximate distinctions can be made.

In any case, it must be remembered that the two divisions of banking are closely related, and in practice one cannot be adequately understood without a knowledge of the other. Thus, one connection between the two is found in the fact that the commercial banker is the custodian of the liquid funds of the community, so that when an individual wishes to put his funds into investment securities to be purchased from or through an investment banker, he draws the amount he needs out of the commercial bank which is the holder of his current resources. It is thus often said, with substantial accuracy, that the funds for investment which the investment banker receives are drawn from the commercial banker. That is to say, the commercial banker is called upon to part with that portion of current funds which represents the means of his customers devoted to the purchase of income-producing investment securities. It is also true that the commercial banker often finds it desirable, in order to keep his own resources at work, to convert some of them into income-producing securities which are issued by an investment banker. A fuller discussion of the rôle of the commercial banker in the field of investment banking is given in Chapters IV and V.

Institutional Distinction

In what has been said thus far, reference has been made to investment and commercial banking as distinct types of financial operations, and the discussion has been carried on as if the two were always separated, *i.e.*, as if it were possible to pick out or designate certain commercial banks as carrying on one kind of operation, and certain investment banks as carrying on another. This clean-cut functional distinction was permissible for the purpose of clarifying underlying ideas, but it does not correspond to what is found in practice. It is, therefore, necessary now to consider commercial and investment banking from the institutional viewpoint, and see how actual banking institutions exist to carry on one, or the other, or both types of operations.

For many years banking or financial institutions have existed which have carried on both kinds of banking concurrently; the practice has continued up to the present time, and is still a prevailing one. The evolution of pure investment banking institutions on a large scale began with the stabilization of government credit in Western Europe and the consequent growth of popular investment in government securities. This resulted in the formation of houses of issue, such as those of the first generations of the Rothschilds. The development of corporate financing enormously expanded the field of operation of such firms in buying, selling and dealing in securities. At the same time, many institutions have exercised both commercial banking functions and some, or in a few cases all, of the investment banking functions. Such institutions engage in what is sometimes called "department store banking," a separate department in the organization frequently being created to exercise each separate function.

In order to bring out more clearly this institutional overlapping within these two fundamental banking functions, it is worth while to classify the principal financial institutions found in this country. Such a classification would be roughly as follows:

1. *National Banks.*—The national banking system was originally organized as a commercial banking system primarily, but it gradually took on investment banking functions, particularly in the farming regions where a large part of country bank loans came to consist of long-term accommodations secured in one way or another by land, though such loans were nominally not permitted by law. Bond investments by the banks and the receipt of savings deposits were also accomplished without specific legal sanction after 1900. The Federal Reserve Act granted a limited permission to invest in land mortgages, and the McFadden Act of February 26, 1927, greatly broadened the investment functions of the national banks by permitting investment of a large fraction of their time deposits in mortgages on real estate, and also by allowing them to enter the business of security issue and distribution.

2. *State Banks.*—The state banking systems were originally organized along lines parallel to those adopted in the National Bank Act. They also have tended during recent years to develop an investment banking business, and it was the fact that they had done so through aiding in the issue and distribution of investment securities, making them severe competitors, that led to the modification of the National Bank Act in 1927.

3. *Trust Companies.*—Trust companies organized under state laws were from the beginning chiefly designed to carry on an investment banking business. At first, in many cases, they devoted themselves primarily to the buying of securities

for clients establishing trusts, but many of them in the course of time developed commercial banking departments so large as to dominate the rest of the business. Within the past twenty years, trust companies have more and more been disposed to take up also the function of securities issue and distribution, either directly or through auxiliary corporations organized for that purpose and owned either by themselves or by their stockholders. Under the Federal Reserve Act, national banks were also given trust powers on a limited basis, later much broadened by the McFadden Act of 1927.

4. Savings Banks.—Savings banks, either mutual or stock, are recognized as investment banking institutions that receive deposits from the community on a time or savings basis and use them to make loans on real estate, as well as to buy other securities allowed by law.

5. Mortgage Banks.—Mortgage banks, best represented in the United States by the Federal Farm Land Banks, devote themselves to the financing of agricultural and real estate development. They sell securities to raise funds to be used in this way, and thus constitute a highly developed, albeit narrowly specialized, type of investment banking institution. The building and loan association is a special but very important variant of the mortgage bank.

6. Investment Houses.—The investment house, sometimes called the bond house, devotes itself exclusively to investment banking operations in most instances. The following chapter is devoted to a full discussion of this class of institution, which supplies investment securities for purchase by other financial institutions or individual investors.

7. Brokerage Houses and the Stock Exchanges.—These organizations buy and sell already issued securities, thus making a market for them. They facilitate the distribution of securities, and constitute a highly important cog in the investment banking machinery.

8. Investment Trusts.—Investment trusts are organizations which issue their own securities for the purpose of raising capital with which to buy other securities. They thus act as securities substitution companies and, as such, facilitate the investment banking process.

9. *Other Institutions.*—A variety of other types of institutions may be properly classified in the investment banking field, although not always thought of in that connection. Thus, insurance companies are properly grouped as operating on the demand or buying side of investment banking, since they are large buyers and holders of investment securities which they purchase in order to keep the funds of their policyholders profitably employed. Large business corporations and eleemosynary institutions are also frequently large-scale security buyers, thus constituting an element in the investment banking organization.

From the brief descriptive accounts just afforded, it is possible to reclassify American financial institutions on the basis of functional banking activities performed, as follows:

1. Institutions engaged primarily in commercial, and secondarily in investment, banking: national banks, state banks and most trust companies

2. Institutions engaged primarily in investment banking, but with commercial banking as an important auxiliary: some trust companies and some investment houses

3. Institutions engaged in investment banking pure and simple: investment houses, savings banks, mortgage banks, investment trusts and brokerage houses.

This reclassification is necessarily imperfect, owing to the varying degree in which different institutions engage in the investment banking business. From time to time individual institutions change the scope of their operations and take on new functions or slough off others. On the whole, however, the investment banking structure of the United States is tending to assume a definitely organized form, notwithstanding the fact that the tendency has been in the direction of uniting commercial and investment banking functions under the same institutional or organizational control. While the same institution may do both kinds of banking, the underlying functional difference is understood and allowed for by departmental organization or otherwise, so that it may be fairly said that there is today a much more distinct and inclusive functional separation of the two types of banking in actual practice than ever before in the past.

The Capital Market

The buyers and sellers of securities taken together constitute what is often loosely defined as the capital market. All of the institutions connected with investment banking, as described above, therefore constitute factors in the capital market. The capital market is to be distinguished from the money market, which includes buyers and sellers of short-term obligations, such as commercial paper, acceptances and government obligations of short date.

The term investment banking, which at times is used in a narrow sense to signify only the purchase of securities from their original issuers and their sale to all types of investors, institutional and individual, is to an increasing extent being expanded to include the operation of the entire capital market.[1] This is quite proper, as the mechanism which has been evolved to take care of and direct the flow of long-term capital is a complicated one, and is so closely interlocked in its various elements that it can best be studied as a whole. This corresponds to the broader view that is being taken of the term commercial banking, which is now frequently used to include all aspects of the money market, including acceptance houses, commercial paper houses, installment financing houses, etc. It is recognized that the individual national or state bank is merely one element in a larger mechanism which can be fully understood only when grasped as one whole.

As a preliminary to a study of the investment banking institutions which together constitute the main factors in the capital market, we shall consider in a general way the character of the demand for capital which comes on the market.

Commercial *vs.* Investment Borrowers

The major factor which determines whether a business enterprise shall enter the money market or the capital market to meet its needs for funds is probably the length of time for which an advance is required, although numerous exceptions to this generalization can be cited. However, there are certain

[1] The term "investment banker," on the other hand, is generally confined in current parlance to one whose business it is to buy security issues for resale. Brokers are usually excluded from this appellation.

purposes for which resort is almost invariably made to the capital market where this is feasible. Among these are the purchase of expensive items of fixed capital, such as plant and equipment, or the raising of a minimum amount of permanent working capital to relieve the business from chronic reliance upon the banks. Repayment of maturing long-term indebtedness is another purpose for which corporations frequently enter the capital market.

The commercial borrower generally seeks funds for temporary purposes, such as seasonal expansion of his inventories to carry him through a busy period in his business, or the anticipation of trade liabilities for the purpose of gaining cash discounts. The special or seasonal nature of commercial banking operation is emphasized by the fact that the customer of the commercial bank is expected to pay off or "clean up" his obligations to it at stated intervals, when such demands are supposed to have passed over. It often happens, however, that such a customer gradually falls into the habit of being more or less permanently indebted to the bank, paying off one note by the issue of another. His borrowing ceases to be seasonal and becomes permanent or semi-permanent. He has then become a prospective customer for investment banking accommodation, owing to the change which has taken place in the character of his credit requirements.

The commercial bank, however, often does not wish to lose him to another organization by simply sending him to that institution or by compelling him to transfer. This is one main reason why many commercial banks have organized their own investment banking departments, or have established institutions controlled by themselves for the extension of investment credit. Through these, the customer of the type under consideration becomes an applicant for investment credit and receives his accommodation from the capital market. He pays off his indebtedness to the bank from which he originally borrowed, retaining his ordinary account with it for the sake of banking service, and still borrowing from it such part of his requirements as are of a purely seasonal and hence commercial credit variety.

A still different type of customer is seen in the borrower who wishes to obtain funds upon a kind of "intermediate" basis for terms of from six months to three years. Such a borrower might, in certain circumstances, obtain accommodation from the commercial bank on the basis of his statement, and the bank might carry his loan along either through renewals promised under lines of credit or, where legal restrictions permit, with actual loans running for the full period of the borrowing. Alternative accommodation is afforded by a resort to the investment market with short-term notes or some other suitable security.

Often the borrower may be uncertain as to which type of bank he should use for his financing. In such borderline cases, the question of comparative cost generally becomes the guiding factor. At times of rising security prices, such as prevailed during most of the third decade of the century, corporations prefer to sell bonds and stocks, and thus gain independence of the banks, even for seasonal and special working capital needs. On the other hand, in times of low security prices and high yields, such as the war period, the banks are called upon to do a maximum amount of financing, much of it designed to raise funds, directly or indirectly, for fixed capital purposes. It was the large amount of bank borrowing for such non-liquid purposes which accounted in part for the severity of the deflation of 1920-1921.

Limitations of the Capital Market

There are certain definite limitations on the efficacy of the capital market as a channel for financing business enterprises. Perhaps the greatest one is the fact that it is not available for small enterprises in the great majority of cases. The commercial bank, since it means to keep in its own portfolio the paper which it takes from its borrowing customers, must merely be convinced itself of its goodness. The investment house, on the other hand, must also convince its clients that such is the case, for it wants to resell the securities it purchases to investors. This reselling function involves considerable effort and expense, and hence it will not be undertaken unless the issue is large enough to absorb this expense and yield a profit nevertheless. A loan of $50,000, for example, is a fair-sized piece of business for a small bank; but an investment banker can hardly afford to undertake to advertise and sell a stock or bond isssue of this size. Only where such smaller loans can be reduced to a uniform basis and handled on a large scale by special institutions, as in the mortgage banking business, is the small borrower on a par with the large one.

Another factor which operates against the small business in the investment banking field is the fact that the large company is already well known to investors through other contacts, and information concerning it is available in financial manuals and other easily accessible places. Thus, the initial sales of securities of the Dodge Brothers' automobile manufacturing enterprise to the public in 1924 was not a particularly difficult matter, since the company already had a nation-wide reputation. The Great Atlantic & Pacific Tea Company similarly has been able to introduce its securities to the general public recently on a favorable basis and with little difficulty. But the investor generally hesitates for a long time before purchasing securities of small local enterprises about which he has never heard.

The Demand for Securities

We have thus far considered the relation of the borrowing government or business enterprise to the capital market, and the conditions under which access to it is sought. There are several channels through which the funds of investors are directed into the capital market, to constitute a demand for securities.

In the simplest case, the investor merely purchases securities from an investment house which has originated them and is selling them for a profit. Such direct investment has always assumed large proportions, and perhaps half of all new investment security issues are absorbed in this way. This direct investment may also consist in the purchase of already outstanding securities from their former holders, thus placing in the hands of the latter buying power with which to purchase new issues in their turn if they see fit.

But many investors do not care to undertake the difficult function of choosing securities for investment, nor do they want to incur the further task of caring for them and watching conditions affecting their value in the future. The simplest course for the investor is to deposit his savings in a savings bank which promises to pay back such sums on due notice and then proceeds to invest them conservatively and pay a moderate rate of interest. The bank thus constitutes an intervening element between the issuer of securities and the investor, performing a number of services for the latter in keeping and profitably using his funds. Also, a special measure of safety for the principal of the investor is obtained.

Where the investor seeks a larger rate of return without wishing to assume more responsibility for the management of his funds, the investment trust has been found suitable.[1] This type of institution sells its own securities and utilizes the proceeds for investment. As it does not make any promise of repayment on demand, or after short notice, of funds left in its custody, the investment trust is free to adopt more speculative policies in the management of its funds. Mortgage banks constitute similar institutions operating under special laws in the field of agricultural and real estate finance.

Finally, individuals place large sums of money with institutions that are formed primarily for other purposes, but which nevertheless gather large sums which they must invest. The insurance company and eleemosynary institutions are in this class.

Types of Investment Banking Institutions

There are a number of different types of institutions performing their own special functions in the capital market, as has already been indicated. The first part of this book is devoted to a detailed description of their organization and operation.

[1] Freedom from management responsibility is obtained by the investor from the fixed investment trusts and those operating along old-fashioned British lines. The same can hardly be said of securities of many recently organized concerns in this field which turn over their holdings rapidly for market profit. The investor must often give such commitments close attention.

The investment house will first be considered as the security middleman. Taken together, these organizations originate new security issues through purchasing them from the govern-

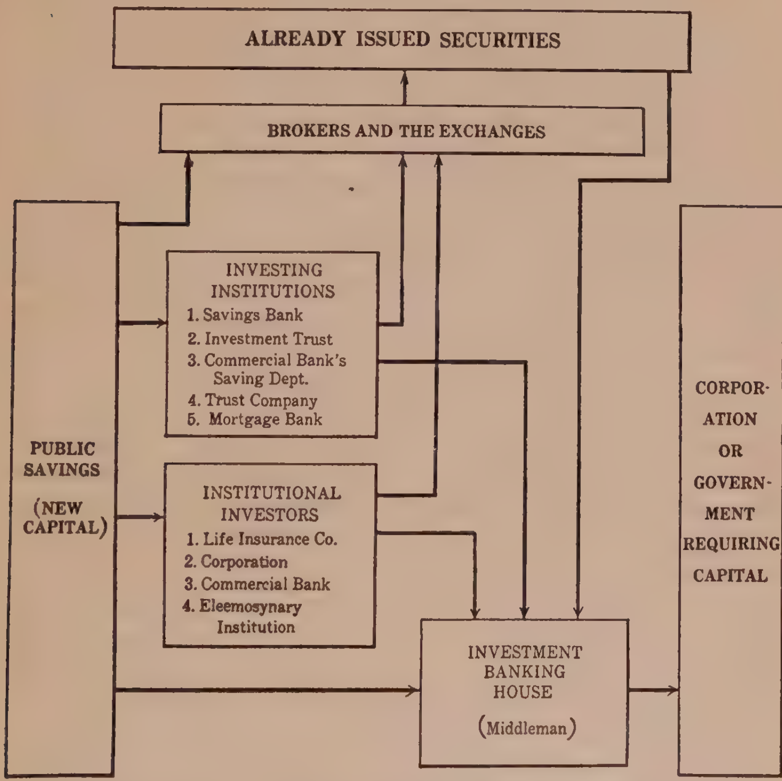

FIG. 1. CHART OF THE INVESTMENT BANKING SYSTEM.
This chart shows in schematic form the movement of capital from investors to corporations and governments which sell their securities. Funds flow from investors through investment houses to the user of capital. Part of these funds comes to the investment banking house through investing institutions and institutional investors. Another part goes into already issued securities; but the proceeds of the sale of such securities will, to a large extent, go into new security issues.

ments and corporations that seek to raise funds in the capital market. Following the investment house, there will be considered the brokers and the stock exchanges, which furnish a market for these securities after they are issued and thus make them marketable from the viewpoint of the individual investor.

After these two broad classes of investment banking institutions, consideration will be given to two other groups of organizations which devote themselves to purchasing investment securities for others. First, there are the specialized investing institutions, such as the savings bank, investment trust, trust company and mortgage bank. Secondly, there are institutions which are formed primarily for some other purpose, but which incidentally carry on large-scale security-buying operations because of the large funds they accumulate in the course of their other activities. The insurance companies, commercial banks, eleemosynary institutions and large business corporations all fall within this class.

This institutional framework of the capital market is outlined in Fig. 1, which seeks to summarize briefly the position of the several types of institutions which have been developed to facilitate the investment of the savings of the public in the securities of governments and corporations that turn to the capital market for funds.

Institutional Transition

It is worthy of renewed emphasis that the classification of investment banking establishments cannot be sharply made according to any logical line of division drawn between institutions performing distinctly separate functions. Functions, as we have noted, are exercised today in combination with one another, and the degree of this combination varies a great deal even over very short periods.

This is another way of saying that the form and types of investment banking are now passing through a transitional phase. New functions and duties are being assumed from time to time by existing institutions. For example, national banks are taking up fiduciary duties and undertaking the organization of securities departments to buy and sell all security issues. Other institutions are sloughing off functions which they have exercised in the past, but which have been found incongruous or unprofitable. The result is to bring about a far-reaching and constant modification of financial relationships. Perhaps the most striking example is that already referred to—the rapid transformation of the banks of the country in their scope of operations since the passage of the Federal Reserve Act in 1913. Still another striking development is seen in the organization of investment trusts subsequent to 1925. Although the latter institutions had previously been but little known in the United States, they have quickly assumed an important place on the market, while at the same time they have developed along lines that were quite unexpected. The consequence has been the evolution of a new type of institution of first-class importance, while a new class of investment security has been placed on the market as a result. It is probable that this process of growth and change will continue for some time among the financial institutions of the United States. Parallel transformations are being noted in other sections of the field of investment banking.

The theoretical bearings of this transitory character of the present situation need to be noted. Some have taken it for granted that because the investment banking structure was by no means complete or final, it was not possible to develop a satisfactory theory of investment banking, much less a definite description of its practice. There would seem to be little basis for any such attitude. The technique of investment banking has attained a practically stereotyped form, at least in its fundamentals. In the same way, the general theory and practice of investment as a process are, from the individual or institutional viewpoint, becoming increasingly well recognized, and are not likely to change under a capitalistic system which is itself already full-fledged and likely in the early future to be subject only to relatively minor modifications. The point at which nothing final can be said and no conclusive opinions expressed is in neither of these matters, but is found in the institutional organization of the investment banking system. That can be outlined only as a contemporary matter.

A discussion of investment banking, therefore, must be developed largely independent of the particular types of institutions by which it is carried on, and with a view chiefly to indicating the processes and methods underlying institutional organization. The latter is important from the immediate standpoint of practical observation. Because, however, it is subject to constant change, the more important analyses of investment banking relate to principles and methods, though they necessarily are represented as being carried out by institutions whose form is passing through continuous alteration. These fundamental principles and practices are treated in Parts II and III of this volume.

A body of principles relating to investment banking is steadily developing and has already assumed in many respects a definitive form. Some portion of the body of doctrine on the subject is still undoubtedly in the form of mere generalizations of practice which have yet to undergo the test of analysis and criticism before they can be accepted as in any sense ultimate statements of fundamental theory. Still other statements which are frequently put forward as representing the theory or principles of investment banking must be regarded as essentially transitory, growing in some cases out of current legal requirements, and in others being the product of the immediate institutional organization of investment banking. In still other cases, the so-called principles of investment banking will necessarily call for restatement or for adaptation, as the institutional organization of the subject enters a new phase.

While these limitations must be constantly borne in mind in dealing with the subject, it has nevertheless, as already stated, reached the point at which it deserves recognition as a definite branch of banking, with a set of underlying ideas and a technique which are peculiarly its own. The purpose sought in this volume is that of stating these ideas and of relating them so far as practicable to the actual technique of the subject, as developed in current practice.

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Chapter II

INVESTMENT MIDDLEMEN—THE INVESTMENT HOUSE

The Securities Business

The present-day organization of society is often termed capitalistic, because its most typical feature is the aggregations of capital goods—machines, railroads, power plants, etc.—owned by large business organizations. In the United States we now have more than a dozen individual enterprises which report that they have in excess of a billion dollars of such fixed assets. These companies must raise capital on a large scale to keep pace with the growth of the country and the improvement of industrial technique, and, not being equipped to reach the widely scattered investment market, they must appeal to middlemen who have developed an organization that is ready and able to gather the funds of thousands of investors.

These middlemen are the chief type of investment bankers in this country. They constitute the central factor in the capital market. On the one hand, they gather the funds of the community either directly from investors or through intermediate institutions presently to be described. On the other hand, they establish contact with those in need of this capital, and direct the stream of new capital to the most promising channels.

In view of the fact that a commitment of capital for investment purposes is to cover a long period of time, it is necessary to evidence it in transferable form, so that the investor may realize upon his investment, should he need the cash for some other purpose.[1] Under legal safeguards, therefore, gov-

[1] While the issuance of securities was not unknown in ancient Greece and Rome, and negotiable bonds were issued by the Venetian State in the twelfth century, large public security markets came into existence only with the growth of corporate enterprise after the middle of the eighteenth century. The corporation became the favored form of organization for large enter-

ernments and corporations issue negotiable securities. These take the form either of bonds—evidences of debt—or shares of stock—showing fractional ownership in the assets of a corporation.

The relatively large issues of securities put out by present-day corporations make many of them widely known, and so they readily lend themselves to modern merchandising methods by middlemen. An issue of bonds of the New York Central Railroad is like any other trade-marked article of commerce; it is known and demanded by thousands of prospective buyers, and so it can be sold at low cost because of the small "sales resistance." This is because the credit of the company has become established and "seasoned" through extended favorable experience by investors with its securities. The investment banker's problem of distribution differs in details, but not essentially, from that of other merchants.

Security middlemen, buying entire issues on one hand and distributing them to numerous investors, large and small, institutional and individual, on the other, handle the bulk of new security issues. However, their services are often dispensed with in the sale of new stock by large corporations, which make direct offering of the shares to old stockholders on a *pro rata* basis. The reason for this is largely of a legal nature. Each share of the capital stock of a corporation represents a fractional interest in the equity existing over and above the debts of the enterprise. Stockholders thus have a claim to their proportional share of the surplus accumulated from reinvested earnings; and to protect their interest in this surplus, the law requires that new issues of capital stock must first be offered to the old stockholders, and only if they refuse or contract themselves out of the privilege of subscribing can the stock be offered on the same terms to outsiders. The result of this situation has been some cleavage in the practices connected with the selling of stocks and bonds, the former being offered for the most part directly to old shareholders, except

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prises because of the limitation of liability to the shareholder which it accorded; and thus it came about that the bulk of security issues have been those of corporations.

in the case of new corporations, while bonds are almost invariably sold through investment banking houses to the public.[1] Because most of them handle chiefly bonds, these investment banking houses are often called bond houses, although practically all of them now handle a substantial amount of preferred stock, and not infrequently issues of common stock as well. In late years, the tendency has been in favor of such common stock issues.

The bulk of the new capital raised in the American market is secured by the issuing corporation, in the first instance, from these middlemen, the investment houses. Every year these organizations put out billions of dollars of new securities. They are in the investment banking field what the ordinary commercial bank is in the field of short-term financing—they gather together the capital of the nation and make it available to those able to put it to work profitably. In their method of operation, however, they are fundamentally different, in that they deal in negotiable securities that are generally known and can be bought and sold with ease; whereas, as we have seen in the previous chapter, the commercial bank uses the method of deposit and discount, in view of the specialized knowledge necessary to value individual commercial loans and the short term of these advances, making the development of a public demand for individual commercial obligations impracticable.

Kinds of Investment Houses

As in all branches of marketing, there has been a considerable degree of specialization among security-selling houses. The broadest classification on the basis of function is into the three groups of wholesalers, retailers and "dealers," or smaller retailers. Within each of these groups, individual firms exercise a varying degree of specialization, some dealing in all kinds of securities, and others specializing narrowly in one or more industries, such as railroads, utilities and real estate bonds.

There are only two exclusively wholesale general investment

[1] In several corporations, the sale of convertible bonds, or bonds with warrants attached to buy common stocks at fixed prices, must be made to shareholders on the same principle, under the provisions of the charter or by-laws.

houses at the present time—J. P. Morgan & Company, and Kuhn, Loeb & Company. Other houses have found it necessary or profitable to supplement their buying or originating activities with a selling organization. The wholesaler relies primarily upon the retailers and the dealers for distributing securities, J. P. Morgan & Company having a list of retailers usually associated with them in selling their new offerings—a so-called "syndicate list"—numbering 1,000 and more at the present time.

Most of the larger investment houses of the present day are a combination of wholesaler and retailer. They both buy, alone or with others in a purchase group, entire issues of securities, and sell them to ultimate consumers, either individual investors or institutions. The following table shows the volume of securities sold by the leading bond houses in the country for the year 1927, sales being divided into those made as syndicate head, or wholesaler, and those made as a participant in a syndicate, which usually means as retailer:

	As Syndicate Head	*As Participant*	*Total*
J. P. Morgan & Co. ..	$502,590,000	....	$ 502,590,000
National City Co. ...	435,616,000	$1,154,695,000	1,590,311,000
Kuhn, Loeb & Co. ...	423,988,000	20,640,000	444,628,000
Harris, Forbes & Co. .	419,086,000	938,319,000	1,357,405,000
Dillon, Read & Co. ..	400,980,000	168,100,000	569,080,500
Halsey, Stuart & Co. .	321,110,000	469,059,500	790,169,500
Lee, Higginson & Co. .	295,600,000	982,872,000	1,278,472,000
Blair & Co.	269,625,000	322,580,000	592,205,000
Drexel & Co.	218,578,000	40,000,000	258,578,000
First Nat'l Bank of N. Y.	169,125,000	659,530,000	828,655,000
Guaranty Co.	162,714,000	1,050,690,000	1,213,404,000
Bankers Trust Co. ...	152,943,000	668,893,200	821,836,200
Chase Securities Corp.	135,896,000	172,550,000	308,446,000
Union Trust Co. of Pittsburgh........	135,000,000	432,515,000	567,515,000
Bonbright & Co.	97,250,000	294,762,000	392,012,000
H. M. Byllesby & Co.	91,500,000	236,400,000	327,900,000
J. & W. Seligman & Co.	90,500,000	220,987,000	311,487,000
Hallgarten & Co.	88,125,000	210,163,500	298,288,500
Equitable Trust Co. .	83,643,000	370,430,000	454,073,000
Brown Brothers & Co.	67,358,200	575,368,000	642,726,200

The above compilation clearly shows that certain of these organizations emphasize origination in their activities, and others distribution. Thus, J. P. Morgan & Company is the only house on the above list which does not join any syndicate merely as participant, for the latter rôle involves chiefly distribution. On the other hand, the National City Company, while a leading originator of new issues, surpasses all other bond organizations in the size and extent of its distribution facilities, with a nation-wide chain of offices in the United States, and a series of branches in Canada and Cuba as well. Harris, Forbes & Company and Lee, Higginson & Company are other investment houses which have developed extensive distributing organizations, as a result of which their originating work has been correspondingly benefited. Bonbright & Company is one of the largest of the specialized houses, its dealings being restricted chiefly to public utility securities. The Union Trust Company of Pittsburgh plays an important rôle in new security flotations because it is closely affiliated with the powerful Mellon interests in that city, and thus joins as a rule in the financing of the numerous properties controlled by them.

The "dealer," as the small retailer is often called, is at the outer fringe of the securities business. He usually takes little or no part in originations and syndicates because his selling ability is too small. On new offerings he will take over 5 to 25 bonds, as a rule, getting his profit from a dealers' allowance provided for in the agreement among the issuing firms, a document known as the syndicate agreement. This allowance varies from ⅛ to 1½ points, according to the quality of the issue and the state of the bond market. The dealer will also frequently purchase in the market a block of bonds of an already outstanding issue directly from investors or other bond houses, and then sell them at a moderate advance. This is called "taking a position" in an issue. Practically all bond houses act in the capacity of dealer in this sense at one time or another, thus furnishing the bond market with an engine for secondary distribution after the offering has apparently been placed with investors by the original offering group.

Specialization in Securities Handled

Specialization among bond houses has long been common. At times, this occurs as a result of the special knowledge needed to handle certain types of securities, such as real estate mortgages and bonds and municipal securities. In other cases, specialization results from the fact that the house appeals to a definite group of clients with limited interests. An example of this is a house specializing in securities permitted by law as investments by savings banks and insurance companies, termed "legals" in the parlance of Wall Street. Lastly, specialization may result from the financial connections of the investment house. The Electric Bond & Share Company, for example, is now an important wholesaler of public utility securities; but this organization is primarily a public utility managing and investment company, its security marketing work being merely a result of, and supplement to, its other functions.

Over a period of time, experience shows, specialization tends to break down in the case of the average investment house. Changing conditions, and the desire to utilize marketing facilities more intensively, make bond houses extend their interests, despite any original specialized organization. Especially after a corps of salesmen have been gathered and trained, the temptation becomes great to give them a more diversified list of issues to offer clients. This tendency to broaden the scope of activity of the individual investment house is visible particularly in the interest manifested in stock issues during the past few years by firms which hitherto have restricted their activities narrowly to bonds.

Other Security-selling Institutions

The business of dealing in investment securities, until the war, was carried on almost entirely by firms specifically formed for this purpose. It was a highly specialized activity. Since the war, however, the old distinction between commercial and investment banks has more and more tended to break down, the former invading at every point the field of investment banking in order to share in the phenomenal expansion enjoyed by the latter. Commercial banks now share in investment banking in two ways: they form departments or subsidiaries to buy and sell securities, and they buy securities as investments under the recently liberalized provisions of our banking laws.[1]

The formation of a securities subsidiary has become the rule with the large city banks. In order to escape the restrictions placed on the banks themselves by law, as well as to avoid danger to the bank from large security losses, these subsidiaries are incorporated separately. Thus, the National City Bank formed the National City Company, in 1911, and the Guaranty Trust Company formed the Guaranty Company. These companies are provided with a separate and substantial capital, with which they carry on the activities common to other general investment banking houses. The stock in the company is usually sold to stockholders of the bank, being paid for automatically in many cases out of a special dividend to bank shareholders, so as to give them no choice as to whether they want to buy the stock or not.

Steps are generally taken to assure permanent identical ownership of the bank and securities subsidiary. Sometimes this is achieved through printing the stock of the securities subsidiary on the bank stock certificate, so that they cannot be detached from each other. In other instances, the stock of the subsidiary is deposited with a trustee for the benefit of bank stockholders.

The securities subsidiary of the bank has a number of advantages because of its connection with a commercial banking institution. It can utilize the same quarters, and it has an excellent list of prospective customers in the clientele of the bank. On the other hand, large clients of the bank also furnish an excellent opportunity to obtain securities for distribution, as the contacts have already been established to lead to such a transaction. An examination of the issues put out by the securities companies of the large banks will frequently show that they are to a great extent of firms which have been banking clients for many years. The bank is already so well versed with the affairs of its large clients that additional investigation is often unnecessary for putting out security issues, and there is less uncertainty as to the correctness of

[1] See chap. i, p. 5.

its judgment. On the other hand, when a client is heavily indebted to a bank, the temptation is sometimes strong to shift the burden of carrying the debt to the public through the issue of securities by the subsidiary.

Smaller banks, instead of doing a full-fledged security business, are often content to act as "dealers" in the narrow sense of the word. They sell securities offered by the larger city banks and investment houses, receiving the regular dealers' commission on such sales. This avoids the necessity of tying up capital in securities pending their sales, and also practically eliminates the risk of loss.

In addition to the commercial banks, a large number of stock brokerage houses have opened bond departments, and thus swelled the ranks of investment houses. Here also the desire has been to exploit further the connection made with clients in other ways.

The efforts of stock brokerage houses to establish profitable bond departments have not been attended with success in every case. The reason for this is that the two activities do not in many instances fit into each other. Where the stock exchange house is one of high repute, with many wealthy customers, the bond department may become nearly as important to it as stock trading activities, and membership in the stock exchange will facilitate such dealings in bonds. But many stock exchange houses have a reputation for prominence in speculative deals which does not help them in efforts to sell conservative bonds and preferred stocks on a low-yield basis. In the case of not a few stock exchange houses, in fact, the management is satisfied if the bond department "breaks even" financially, regarding the investment activities as worth while merely because they add to the prestige of the firm.

Form of Investment House Organization

The form of organization of investment banking houses shows wide variation at the present time. Originally, practically all the firms were partnerships, in which the several members often possessed equal power. Most of the older firms retain this form of legal organization, and several of them have a dozen or more partners in the business. Where membership is desired in security exchanges, which generally admit only unincorporated firms, this form of organization is, in fact, compulsory.

The corporate form of organization is now becoming increasingly common among investment houses. Perhaps the greatest advantage to be gained is limited liability for the principals of the firm who own its stock. A second advantage is more centralized organization. In a partnership it is difficult in practice to curtail the powers of individual partners,[1] but in a corporation there is a fixed hierarchy of officers, from the chairman of the board or the president down. The corporate form also permits the sale of stock to outsiders, for the sake of raising additional capital or interesting influential persons in the firm, without passing on at the time any share in the management of the business. This latter objective has also been attained in many partnerships through securing limited partners who have no voice in the business. However, it is necessary to conform to the legal requirements concerning limited partnerships in each state in which business is transacted, if such limitation of liability is to be assured in practice.

As a result of the entry of the commercial banks and stock brokerage houses into the security distribution field on an extensive scale, a change in the typical form of organization of the investment house has been stimulated. It has further increased the number of incorporated organizations. On the other hand, brokerage houses going into this field, as well as many old-time investment houses who retain membership in large security exchanges, maintain the partnership form of organization, which, as has already been seen, is a necessary prerequisite for membership in these exchanges.

Internal Organization

Because of the great diversity in types among bond houses, their internal organization shows wide variance. The accompanying chart depicts the actual organization of a typical firm doing a wholesale and retail business. Whatever the division

[1] One large house has secured centralization of control by requiring each partner, on entering the firm, to give the leading partner an undated letter of resignation, which becomes effective on the latter's acceptance at any time.

in responsibility among departments and individuals, practically every bond house is organized for the functions of:

1. Purchase of securities
2. Sale of securities
3. Trading in issued securities
4. Statistical analysis of securities
5. Mechanical handling of and accounting for the transactions of the firm

In most investment houses, the departmental organization conforms fairly closely to these basic functions. The management of an investment house is also organized as a rule along these departmental lines. Where the corporate form of organization is adopted, the department heads are frequently vice-presidents and directors. In this respect, investment house organization differs from that of most commercial banks where the board of directors consists chiefly of outside persons, and the operating officials are simply employees. In a partnership the different departments are headed largely by partners; while vital decisions, such as the purchase of new security issues or the adoption of general policies, which in a corporation the board of directors would make, are made in conferences of the partners. The general factors governing the operation of each such department will now be discussed.

Purchase of Securities

The purchase of securities from the issuing company, either as member of an originating group or as dealer from other houses, is a difficult matter, especially under present conditions of intensive competition for desirable new issues. In originating a new security issue, the investment banker exercises the important social function of directing the flow of capital into industry. He must, for his own protection, determine the ability of the applicant for capital to use investment credit safely and profitably, just as the commercial banker analyzes his customers' statement to fix a safe "line of credit."

The work incidental to the origination of security issues is concentrated in the buying department. Here proposals for new offerings are received from many sources and put in definite form. Close contact is maintained with the statistical department in the study of these proposals. In a number of houses, the statistical department is included in the buying department, or made auxiliary to it. The legal and other details of security buying are also handled in this department.

The syndicate department, separately organized in many of the larger houses, handles the work involved in the organization of groups of investment houses to coöperate in the sale of securities originated in the buying department.

Usually the ultimate decision as to the purchase of new securities rests with an investment committee, consisting of several or all the partners of the bond house. This investment committee is the counterpart of the loan committee of the board of directors of a bank. It sifts out the desirable proposals from among the many applications for loans and stock sales coming to it. In a well-managed investment house, the decisions of the investment committee are based on a mass of data received from the issuing company, checked and supplemented by the statisticians of the firm and associated engineers and accountants working under the direction of the partner in charge of the buying department.[1]

The question of the relationship between the investment bank and the corporation on whose behalf it has issued securities is important and interesting. In the case of the commercial bank the borrower, as is well known, submits a statement which is analyzed by the credit department of the lending institution, and then, if the statement is approved, funds are placed to the credit of the borrower. The bank is the holder of the paper of the enterprise, although it may and frequently does transfer this paper to some other institution, either through sale in the open market or rediscount. Sometimes, where the amount of money involved is large, some participation of the banker in the affairs of the borrower is provided. Because he is largely concerned with the liquidity of the borrower, as well as with his solvency, and because he frequently has a title to portions of the property of the borrower, the banker is sometimes even allowed a seat on the board of directors so that he may be able to keep track of what his customer is doing. In investment

[1] For a fuller discussion of the technique of security-issue buying, see chap. xvii.

banking this close relationship is so general as to be well-nigh universal. The investment banker, intimately concerned as he is with the affairs of the corporation for which he has sold bonds, since the continued meeting of the obligation on these bonds is essential to the maintenance of the investment banker's prestige, often takes such a voice in control as a matter of course. He demands a seat on the board of directors of the concern, and in some cases he even undertakes to prescribe its entire management. To assure this, he may acquire and hold a substantial stock interest in the company. This kind of power over the affairs of the borrowing enterprise represents the correlative of the moral responsibility which he has assumed toward the holder of bonds or stock he has sold.

Where this management function is well performed, it of course gives the buyer of bonds an assurance that the banker has knowledge of what is being done by the borrowing concern, and also of better management. This factor generally proves an important consideration in inducing the bond buyer to part with his money, and explains why investors have learned to place so much stress, in purchasing securities, on the character and reputation of the house of issue.

The history of American business has hitherto been marked by a steady increase in the influence of the investment banker for these reasons. He now exercises a voice in the management of more individual business enterprises than ever before. The "entrepreneur" of the economists, who in traditional economic theory is supposed to bring together the "factors of production," including capital, is a figure rapidly fading from the business horizon. In the railroad industry, with its aggregate investment of more than twenty billions of dollars, the executive is usually held closely under the thumb of the banker who has lent his name as issuer to the hundreds of millions of securities the company has sold to the public. In numerous industrial concerns, the banker element is dominant on the board of directors. Even in the public utility industry, where the technically trained engineer for a long time retained control, the present period of widespread consolidation has resulted in bringing the banker into a more prominent place.

In a competitive society, rivalry between individual enterprises results in a kind of natural selection and the survival of the fittest—financially. Hence, financial difficulties generally mean that control of an enterprise is to shift from its promoters and executives to the bankers who are asked to supply new capital. The early history of the General Motors Corporation, involving two separate battles for control between W. C. Durant, its executive head at that time, and a powerful banking group, ended, as most such struggles end, with the victory of the bankers. Similarly, the great packing house of Armour & Company fell under banking control when post-war financial difficulties hurt the fortunes of the controlling family.

The investment banker gains in power not only through the misfortunes of business enterprises, but also through the death or retirement of their founders and chief executives. There are many cases, such as that of the Vanderbilts and the New York Central Railroad, where family management gradually changes to banker management. The descendants of the founders of great family fortunes seldom care to lead the strenuous life of their forbears, and they then welcome the opportunity to shift the responsibility for the continued successful operation of inherited enterprises to some outstanding banking firm, with which they thereafter become affiliated in the control of the property.

Sale of Securities

The sales department is of the greatest importance in most bond houses. An efficient selling organization, through assuring a market for new security issues, gives the investment house a reputation which makes it a popular member of new offering syndicates, and thus facilitates the work of the buying department also.

The sales department of an investment house consists of a corps of individual salesmen under the supervision of a sales manager. One large New York house reported in 1928 that it had more than 500 salesmen; smaller ones have only a few. These salesmen gather, through the years, customer lists which they are constantly trying to enlarge. In this way, the average client of the house deals only with one salesman, thus introducing a large personal element which is one of the outstanding characteristics of investment banking in this country. The strength of many an investment house is an adequate, trained and loyal sales force; and in the interest of efficient public service it is necessary that these salesmen, as far as possible, should do their work in the spirit of trustees for the investors' interests.

The bond salesman depends for his compensation in most cases primarily upon a commission on each bond sold, if the bond is one of a new issue of securities. He gets as a rule no return from turning in orders for securities already outstanding which must be acquired in the market. This system results in a steady pressure to sell new issues, and tempts the salesman to switch his customers out of securities they already hold and into new offerings. Many houses pay no fixed salaries in addition to these commissions, but allow older men a drawing account against future commissions. Others, recognizing the general good will brought to the institution by a salesman, give a substantial fixed salary which is paid regardless of the commissions earned, and allow commissions on sales in excess of a minimum amount.[1]

The sales department is aided in many houses by an advertising department, which seeks to extend constantly the list of clients by mail, periodical and newspaper advertising.

The Trading, Statistical and Other Departments

In larger bond houses, the trading department assumes substantial proportions. This is so because it must both purchase in the market many of the bonds sold by the sales force, and also get rid of a mass of bonds which are brought into the house by the latter as a by-product of present methods of bond selling, involving as it does frequent switching of investors from old issues into new. However, this department is generally placed under the supervision of the sales or buying department.

[1] Security selling is discussed at greater length and in more detail in chaps. xviii and xix.

A new offering of securities is not necessarily ideal material for merchandising by the sales department. In fact, already outstanding seasoned bonds can often be handled more safely and with far less overhead, and therefore with larger profit. A good trading department can pick up, either in the market or from large private or institutional investors, several hundred bonds of an issue which is recognized as selling too low. They can then be resold at a sufficient advance in price to make the operation profitable.

The trading department is also kept busy disposing of bonds which clients have turned in, receiving in exchange bonds of a new issue which the firm is eager to sell. Frequently, a salesman out to sell a new issue will be met with the cold reply that the investor has no funds available for investment at the moment. But, if experienced, he will not be dismayed, for he can ask the investor to turn in some security he has, perhaps at a price somewhat above the market, and take in exchange the new issue on which a profitable commission is being paid. The trading department then faces the task of passing the bonds received in this way back into the market; and, if ably managed and if market conditions are not adverse, this can frequently be done by gathering substantial blocks of bonds in this way and selling them to some institution or other dealer at a small additional profit to the house.

Another function sometimes performed by the trading department is the making of secondary markets in issues originally offered by the investment house. Finally, the trading department, or the trader attached to the buying or selling department, almost invariably handles the execution of commission orders for customers in securities which must be purchased in the open market.

As a result of the activities of the buying, selling and trading departments, the investment house has a constantly changing volume of inventory. Many houses have sought to give unified thought and control to this problem by establishing an inventory committee composed of heads of each of these departments. This committee can then determine the wisdom of entering into new originations, the necessity for pressure on the sales department to clear the shelves of unsold issues, and the policy to be followed by the trading department in adding to or reducing the stock of securities on hand through the market.

The statistical department, when separately organized, serves the others with facts and figures required to reach intelligent judgments as to values. When a new financing proposal first arises, this department analyzes the company, the industry and the market for similar securities. It makes up a "circular" and gathers other data bearing on the issue, when the actual offering is made. It helps the salesmen in answering questions of prospective clients, and gives them additional data to push sales. It continually analyzes securities to guide the trading department; and, finally, it prepares special studies and circulars used as part of mail-order and advertising campaigns, as well as press "releases."

The statistical department also acts as a service agency for the benefit of outside investors. A bond house of standing, especially one which advertises frequently, receives many general and specific inquiries which must be answered. These are turned over to the statistical department. In this way, contacts are established with investors. One device frequently used to further this development is to invite investors, both clients of the house and others, to send in their holdings "for analysis." The list is then studied by the statistical department in the light of certain general investment principles, and exchanges are suggested, usually into issues sponsored by the house making the analysis and which it is seeking to distribute to investors. Furthermore, the list is retained and a permanent record of the customer's holdings is thus secured. This can be used in selling him securities in the future by suggesting shifts from time to time from issues on the list into new offerings of the investment house. This is generally done by a salesman assigned to that particular account.

The statistical department also keeps a record of bond redemptions and, to a certain extent, of important developments affecting individual issues. This permits it to advise clients accordingly in timely fashion by form letters to small investors and, at times, special letters to large investors, thus giving them a large measure of personal service and at the same time putting the house in a position to suggest specific exchanges and purchases of its securities. Competition among houses is raising the standard of this service which investors are coming to expect.

The accounting department of the investment house keeps the records of both security and money transactions. Cost accounting, auditing, budgeting and statistical analysis of records have not been carried far in this field, a study of typical bond houses reveals. However, coöperative studies are being made for the purpose of improving practice in this respect. Many houses restrict their bookkeeping activities to the "cage routine" involved in keeping records of cash and securities, the bookkeeping on customers' accounts, and the income and balance sheet. Few have an auditor permanently attached to the organization, and budgeting of expenses is as yet not at all common. Sales data analysis to determine the average cost of selling bonds has been worked up in a few instances, as has also departmental expense analysis to check on the profitability of the important operating departments. Much remains to be done to bring investment house accounting up to date.[1]

Finally, the investment house must build up an organization for the mechanical handling of securities. This involves a department for the receipt and safe-keeping of securities, a mailing department, and one for the handling of coupons and redemptions. This type of service, like the statistical service, is coming to be expected by customers in many places, as a result of keen competition in service among the houses.

Branch Organization

Investment banking is characterized by a far greater development of branch organization and activity than is found in commercial banking in this country. The American system of bank organization remains chiefly one of individual units, although in our large cities, as well as in the State of California, branch banking has made much progress. The high

[1] See Report of Sub-Committee on Cost Accounting of the Business Problems Committee, *Proceedings* of the Investment Bankers Association of America, 1928.

degree of regulation and government control to which banking has been subjected has made it difficult to expand the activities of individual banks to cover a large area, although this has been accomplished to some extent through the formation of holding companies owning stocks of a number of individual banks.

In the investment banking field, which has been regulated to a far lesser extent, the same causes have not existed to localize the operations of the individual investment house. As a result, a number of the leading firms have branches in the principal cities from coast to coast, connected by telephone and leased wire connections so that they may be operated together to a large extent. Even the security subsidiaries of banks, such as the National City Company, have established a string of branch offices in a number of outside cities, and thus have been able to reach investors throughout the country with their own organization.

Larger branches usually have a complete organization of their own along the lines outlined in the above discussion. This applies especially to the many houses which began business in some large outside city, like Boston or Chicago, and have since established offices in New York, which has gradually become their most important center. Smaller branches retain a skeleton organization only, usually including a branch manager or assistant sales manager, a corps of salesmen, and a small accounting and cashier department, as the main office may be too distant to permit the handling of customers' accounts there. Where branches are maintained within the same city, as is done, for example, by many New York houses, all bookkeeping and cash transactions may be concentrated in the main office.

While the smaller branches thus largely restrict their activities to the sale of securities, it has been found good practice to give each branch as much autonomy as possible, because of the varying tastes of investors in different regions. When the house is putting out a new issue, it is customary to invite branch managers to take on as much of it as they think can be sold within their territory, always having it understood that each branch will coöperate as far as possible. Where efforts have been made to assign arbitrarily a certain quota to a branch, results have frequently proved disappointing.

Not only do the investment houses expand their field of operation through branches, but they also send out salesmen to cover smaller towns and even rich rural districts. These out-of-town salesmen give investors residing within a radius of, say, 200 miles of the city in which the office is located, a direct personal service and the opportunity to do business with a leading house. As the larger houses thus expand their activities geographically, they constitute strong competitors of the local houses and banks who seek to sell securities in their own territory. However, this competition doubtless has raised the standards of the business in the smaller towns, and as such has generally been a desirable development from the point of view of the individual investor. Efforts to impede such outside competition in some states through discriminatory blue-sky laws are discussed in Chapter XXII.

Financing the Investment House

In studying the financial problems facing the investment banker, we shall take as a typical house a relatively small firm doing both an issuing and a selling business. The largest houses have such powerful banking connections and financial resources that the same considerations do not always apply to them. The smallest houses, because they seldom purchase securities outright for resale, have few and simple financial needs.

The capital of the investment banker is usually a definitely contributed sum, which should be in some substantial proportion to his average outstanding liabilities, actual and potential. It is quite true that a good many investment bankers regard themselves as being virtually in the brokerage business, and so are disposed to think that they can "get along" with practically no capital at all, provided they have good opportunities for borrowing at banks. This is not as hazardous as it is in the case of the commercial banker, who, a hundred years ago, often undertook to set up a business in this same way. The lower degree of hazard, however, is due merely to the fact that the same insistence on immediate cash payment of liabilities, such as deposits and note issues, does not exist. The internal risk involved for the enterprise itself is not less in one case than it is in the other. An investment banking house should be adequately capitalized, and its capital should be paid in, before beginning business.

The capital of the investment banking house is of course invested in some small degree, just as in the case of the commercial bank, in equipping the institution and obtaining a definite headquarters for it, either through purchase or rental. Whatever this outlay may be, it is generally a small percentage of the total capital, and should be regularly reduced by writing off until it has been cut to a nominal amount. After providing for working capital to be used in current running expenses, overhead outlays, developmental work and the like, the remainder of the capital originally contributed constitutes the fund which the concern has in hand for the purpose of buying securities for sale and guaranteeing the fulfillment of obligations it undertakes to those who wish it to issue or underwrite securities. The fund so engaged is not only an evidence of good faith and the basis of the concern's business, which to a corresponding extent relieves it of the necessity of borrowing, but it represents a guarantee to customers that the concern is responsible, and that even though it may incur some losses in the natural conduct of its business, it will be able to write them off.

We may most clearly explain the methods by which the investment banker finances himself by taking the case of a house which has embarked upon the business of floating a loan on behalf of a corporation. It may be assumed that the free or available capital of the investment banker is $1,000,000, and that he has been asked to float an issue of $1,000,000 in bonds on behalf of some industrial enterprise. It is evident that he is theoretically able, making no allowance for his current necessities for running expenses and so forth, to take up this issue and hold it in his portfolio. He may, in other words, make the loan himself, resorting afterward to the sale of the bonds to others with such commission or profit to himself as he may see fit. If now he finds it convenient or profitable to dispose of only $750,000 of the bonds, he will be in the position of carrying $250,000 himself out of his own capital, or, in other words, he will have subscribed to a quarter of his own issue. As a matter of fact, most investment bankers do not like to do this, and they see a lack of success in an operation which has left them with a substantial residuum of bonds or other securities that are not sold. If the investment banker does succeed in selling the entire issue, his capital has served simply to enable him to make the needed advances to the borrower pending sale of the securities to the public. As he is bringing out successively or simultaneously a number of issues, his capital may be almost entirely engaged in carrying the temporarily unsold portions of each issue, thus avoiding to that extent the necessity of calling upon banks for extensions of loans.

Use of Bank Credit

As a matter of fact, most investment bankers are unwilling to take over the placing of issues which in the aggregate equal only their own capitalization. The work and detailed investigation involved do not warrant them in undertaking transactions on which the turnover is no larger than their own contributed capital. Accordingly, they are inclined to seek the assistance of commercial banks for the purpose of obtaining advances which will practically carry for them the outstanding unsold issues in which they have participated. They thus become perennial or semi-permanent customers at banks, and they look to the latter to furnish the means necessary to the conduct of a large volume of business. In such an event the capital, originally paid up and deposited in cash with bankers, constitutes a fund which merely supplements the much larger volume of credit which is secured by loans—mainly collateral loans on securities purchased—from the banks.

Enough has been said of the theory of the investment bankers' issue and loan operations to make it clear how their capital is used and to indicate that it may be engaged either in actually buying securities for sale, or in establishing a basis for credit with the banks, such credit being advanced primarily on the security of deposited collateral, upon which a high percentage of the market value is usually loaned.

The use of bank credit is the first important way in which the investment banker enlarges the scope of his operations beyond the limit allowed by his own capital resources. An equally important expedient is the formation of syndicates of bankers, who through coöperation among themselves are able to reduce the liability of each on any one transaction and vastly speed up the process of distribution to the public by letting each sell only a relatively small portion of the issue to his clientele. This coöperation among individual houses on individual loans, which exists in commercial banking in only a rudimentary degree, is discussed fully in Chapters XVII and XVIII.

The investment banking house runs the constant risk of having its liquid capital tied up because of the failure of the public to take new issues of securities after they have been acquired and paid for by the investment house. The smaller house can frequently get aid from the larger ones, the big organizations often aiding dealers by taking back when the market becomes bad bonds which had been allotted the latter. This fills up the shelves of the large houses, of course, and may at times strain even their facilities.

The large houses, moreover, generally have excellent banking connections, and they can expand their capital easily by the expedient of collateral loans. On the other hand, the banks will not usually lend more than 80 to 90 per cent of the value of even the highest grade bonds to them, so that great capital resources are needed in order to maintain the firm in a liquid condition and permit it to take advantage of new investment opportunities as they come along. Very few investment houses which are honestly run get into financial difficulties, provided the banking situation is normal, because of the relatively small amount of their own capital needed in relation to the size of their undertakings. However, where the investment house retains large interests in the companies which it finances, and where it carries out a number of private deals which do not involve public financing in the first instance, such as reorganizations and mergers, the house must frequently have command over several millions of its own free capital at all times.

While investment houses practically never make their statements public, neither balance sheet nor income account, indications are that the large organizations utilize from $10,000,000 to sums in excess of $100,000,000 of their own capital, in addition to what is borrowed from the banks.[1] This can be judged from details concerning the estates of investment bankers as filed in surrogate courts, and from the amount of capital invested by commercial banks in securities subsidiaries. Thus, the National City Company, the largest investment house in the country from the point of view of volume of sales, had in 1929 a capital of $50,000,000 and a substantial surplus, but no statement was available outside of these figures, so that the total assets could not be learned. When the Bank of America of New York merged in the same year with the old investment banking house of Blair & Company, Inc., a house regarded as being only of moderate size, the value of the capital of the latter was placed at more than $60,000,000, and its owners actually received stock of the bank having a market value in excess of this sum for their company. Small local dealers exist whose capital probably does not exceed $10,000 to $20,000. It is unfortunate that no publicity is given statements of investment banking houses, for the public cannot gauge their financial strength, as can be done for banks from statements required by governmental regulating authorities.

A way of cutting down the amount of liquid capital which an investment house must possess has been recently evolved in the investment trust. Many investment houses are forming such organizations to aid them in distributing securities, as their assured participation in new offerings reduces to that extent the possibility of the investment house tying up its own liquid capital in any one undertaking. A fuller discussion of

[1] In California, the Investment Dealers Audit Association has been formed by investment houses, and once each year a complete detailed financial statement is submitted to a firm of accountants by members. This report is held confidential, however. Blue-sky laws also generally require the submission of financial statements by dealers seeking to be licensed, as shown in chap. xxii.

the investment trust in relation to the investment house will be found in Chapter IV.

Summary

The origination and distribution of security issues, the basic functions of investment banking, are carried on chiefly by specialized institutions called investment houses. These firms, organized mostly as private banking houses, specialize among themselves to a large extent, some stressing wholesaling or retailing in their activities, while others restrict their activities to specific classes of securities. The ranks of the investment houses have been swelled, furthermore, by the addition of security companies or departments of commercial banks, and by many brokerage houses which have opened what are called "bond departments," devoted to new security offerings.

The departmental organization of the investment house conforms as a rule to its chief functional activities. Houses which engage in originating new security offerings have a buying department which receives and studies proposals for new financing, and prepares them for sale. The work of distribution rests with a sales department, the nucleus of which is a corps of salesmen working largely on a commission basis. Advertising is assuming a growing rôle in supplementing the activities of the salesmen. A trading department is generally maintained to handle purchases and sales for the house and its clients in the open market. The accounting, security handling and other operating departments are organized separately.

Looked at from a broader viewpoint, this type of institution appears admirably appropriate for expanding the number of investors and building up a wider capital market in a rapidly growing country in which investment is a relatively new popular activity. The stress upon the sales problem means that the investment house is organized primarily as a merchandising institution. There are certain aspects of this system which are not altogether desirable. For one thing, the individual salesman seeking his commissions is not always an impartial advisor to his client. Secondly, the aggressive sales and advertising efforts of the many investment houses lead to great duplication of effort and much useless switching from old to new issues.

While the investment house is the central factor in the flow of long-term capital from investors to corporations and governments, it is concerned primarily with new issues of securities as they appear. But new security offerings appear at any one time only in small amount compared to the total volume of old securities already outstanding. Those who own already outstanding securities, the total amount of which is estimated to be well in excess of one hundred and fifty billion dollars, often wish to sell them, while others may wish to purchase them, either for long-term investment or for speculation. Accordingly, the brokerage house, which performs this function of buying or selling securities as agent, has assumed an important rôle in the investment banking business; and in the following chapter the characteristics of the brokerage business are discussed.

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Chapter III

FACILITATING INSTITUTIONS—BROKERS, DEALERS AND THE STOCK EXCHANGES

The Need for a Securities Market

Because investment is fundamentally a long-term commitment of funds, one of the greatest problems it gives rise to is the creation of a market where the individual investor, who buys from the investment house described in the preceding chapter, may dispose of his securities at will. A buyer of bonds with, let us say, a maturity of fifty years is almost certain to wish to dispose of his holdings long before this period has elapsed. He may need the money for other purposes, or he may wish to sell them and invest the proceeds in something else. He may die, and the executors of his estate will want to liquidate his investments in order to carry out the provisions of his will.

The quality of being readily salable without substantial loss in value is termed marketability. This exists where the price offered for a security is not much below that at which it can be purchased at the same time. Every investment that has any apparent value has this quality to some degree, as may be seen from the daily reports of the security auction houses, where securities wholly unknown even to the banker are bought and sold for a consideration. But there is a wide difference between marketability in the highly uncertain market of the auction room and marketability on an organized exchange, where the execution of the orders of millions of buyers and sellers results in the maintenance of a close market in which billions of dollars of stocks and bonds may be turned over with little effect on the market price.

It is the existence of this organized securities market in the background which has made possible the growth of the investment houses described in the preceding chapter, houses which purchase some ten billions of new securities annually and find a ready market for them among all classes of investors. These investors buy so freely only because the bulk of the securities offered are readily marketable, so that they can liquidate the investment when the need or desire arises. Furthermore, this market has facilitated enormously the direct sale by corporations of their own stock to shareholders for the same reason. Marketability in the field of investment banking is the counterpart of liquidity in commercial banking.

From the social point of view, the benefits derived from a securities market, including brokers and the stock exchanges, are enormous. When business activity of any kind is carried on by numerous small and little-known enterprises, the cost of securing capital is often high, and at times so exorbitant as effectively to prevent expansion. It is only when the large-scale corporate organization is adopted, and securities become widely known, that a market can be created for the raising of large amounts of additional capital at low cost. Doubtless the ideal form of business organization, for the purpose of financing at lowest cost, is the amalgamation within every line of activity of all enterprisers into a few powerful companies whose bonds and stocks are listed on the stock exchange, which would then reflect in the value of its listed shares substantially the whole material wealth of each country. This ideal is doubtless being approached in many countries. Professor Pigou estimated in 1918 that 60 per cent of English wealth was represented by securities. In the United States, the proportion is much smaller, despite the general trend evidenced in recent years toward consolidation and the capitalization and public issuance of securities against all kinds of companies of even relatively small size and in highly specialized industries. There are about $150,000,000,000 of securities outstanding in this country—two-thirds of them listed on the New York Stock Exchange—while the aggregate national wealth is usually estimated at about $410,000,000,000. Thus, about 37 per cent of the national wealth of the United States is represented by securities, according to these very rough estimates.

The organization of a market for already issued securities predates the birth of our investment banking houses. The reason for this is that it was customary for governments and large enterprises to sell their securities directly to investors before the practice of underwriting their sale by bankers led to the formation of investment houses as middlemen. The sale of Revolutionary War bonds and the formation of banks during the last two decades of the eighteenth century first created an investing class, and to serve them individuals here and there set up in business as brokers.

The typical stock and bond broker differs from the investment house or securities middleman in that he has no dealings with the original issuer of securities. He stands between investor and investor. He does not as a rule acquire title to the security, but acts merely as agent for the buyer or seller and gets a commission for his services. At times, however, he may choose actually to buy a security outright from the seller, and then sell it in his own right to the buyer. When he thus acts as a principal, and actually acquires title to the securities in which he deals, he is said to "take a position," and may more properly be called a dealer than a broker.

Security exchanges are merely aggregations of brokers, who build up machinery which permits them to trade readily one with another at a single place. The security exchange, like the security broker, grew up as the counterpart of the brokers and exchanges already developed for the trade in corn, slaves and other staples. These slave and commodity exchanges have existed in commercial centers since ancient times.

Types of Brokers and Dealers

A broker executes an order in the character of agent for a principal. A dealer buys and sells securities on his own account. In the former case, the broker does not take legal title to the securities; in the latter, the dealer owns the securities he buys and sells.

Where a securities market has been fully organized, the broker predominates. Where trading is still carried on in relatively informal fashion, and the number of buyers and sellers is not large, those who create a secondary market often act in the capacity of dealers. Unless they are willing to do so, it may prove difficult to find bids for and offers of the less active securities at any one time. The lack of adequate trading machinery for bringing buyers and sellers together, and the desire for a larger profit on each transaction because of the small volume of turnover, further explain this tendency.

A compilation made in 1927 showed that there were about 7,600 security brokers and dealers in this country, of whom the great majority were interested in making a secondary market for securities of one kind or another. Only a fraction of these specialized in the highly articulated type of brokerage business connected with operations on a stock exchange. However, the stock broker who is a member of the New York Stock Exchange, and often of other exchanges as well, is by far the most important cog in the machinery for creating a secondary market for securities beyond the new issue stage. This type of broker stands ready to buy or sell securities through these exchanges, and in accordance with their rules, receiving uniform commission rates fixed by the exchange authorities. The large brokerage houses, like other successful financial institutions, have expanded the scope of their activities beyond the mere purchase and sale of securities for a commission. They have developed bond departments, which are usually miniatures of the investment banking houses discussed in the previous chapter. Many of them do business on commodity exchanges also.

A very important feature of the service of the brokerage house belonging to the large exchanges is the arrangement of margin transactions, where the buyer of securities merely pays a fraction of the purchase price, the broker arranging to borrow the rest from a bank, giving the securities so purchased as collateral. In this respect, he acts as an agent for the buyer in arranging a bank loan. Another special function of these stock brokers is to arrange short sales. In this instance, the broker sells securities for a client who does not possess them, but who expects they will decline after a time, when he will be able to buy back at a lower price the securities he has sold. The broker arranges to borrow the securities sold short from a third party in order to deliver them to the purchaser. The diagram in Fig. 3 explains a short sale.

There are 1375 members of the New York Stock Exchange, of whom over 500 have offices in the financial district in New York City. The remainder are out-of-town houses and individual traders. A dozen of the leading brokerage houses generally account for the bulk of the orders which are exercised on the floor of the stock exchange.

The investment houses discussed in the preceding chapter also do a large volume of brokerage business in most cases. Although primarily interested in selling securities which they themselves originate, they are compelled to execute orders for other stocks and bonds, at the established uniform commission rates, in order to give their clients a complete service and so

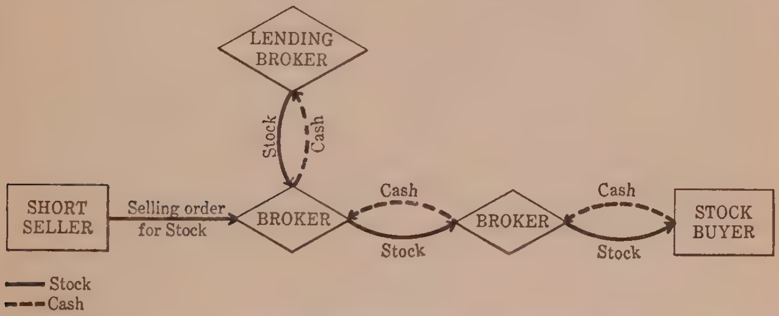


Fig. 3. Diagram Illustrating a Short Sale.

The short seller orders his broker to sell stock he does not own, expecting a decline in price and an opportunity to buy back at a lower figure. The sale is made on the floor of the exchange to another broker representing the security buyer. The seller's broker then borrows stock from another lending broker, and delivers it to the buyer's broker. The lending broker happens to be carrying this stock for a customer. The lending broker makes a loan of the stock against the deposit of cash which the short seller's broker has received from the buyer's broker.

retain their patronage. Some of these houses belong to the large exchanges, while others do their exchange business through other brokers. This function is performed, as has been seen, by the trading department of the investment house.

While the bulk of stock trading takes place on the exchanges, the same cannot be said of dealings in bonds. There are many dealers in the bond market whose chief function is to buy and sell large blocks of issued bonds, both listed and unlisted. It has been estimated that the transactions in bonds on the New York Stock Exchange, the one important organized bond market of the country, represent perhaps 10 per cent of the total sales of bond issues listed on the exchange. The bulk of the sales are made by large financial institutions directly through brokerage and investment houses acting as bond dealers. An insurance company wishing to dispose of a block of 1,000 bonds of $1,000 denomination would probably find the stock exchange a very poor market for so large an offering, since here there are no speculators ready to pick up large blocks of securities at small concessions in price. But a bond dealer who knows of many savings banks and insurance companies ready to take these bonds in large blocks at a uniform price can make a good profit by buying them at, say, 97½ and selling them at 97¾. This profit of $2,500 can frequently be earned in a few minutes of telephoning by a well-placed bond dealer.

There is also a large group of brokers and dealers who specialize in making a market for securities listed on no exchange. This market is referred to as the unlisted or over-the-counter market, because business is transacted within the office and "over the counter" of the individual broker or dealer, rather than at a central organized trading place known as an exchange. A more correct name under present conditions would be the "over-the-telephone" market, for the great bulk of the orders are consummated by phone calls from house to house. In over-the-counter trading dealers predominate, for the market is often too narrow to make it practicable for a buyer and seller to be brought together through the intermediary of the broker.

Organization of a Brokerage House

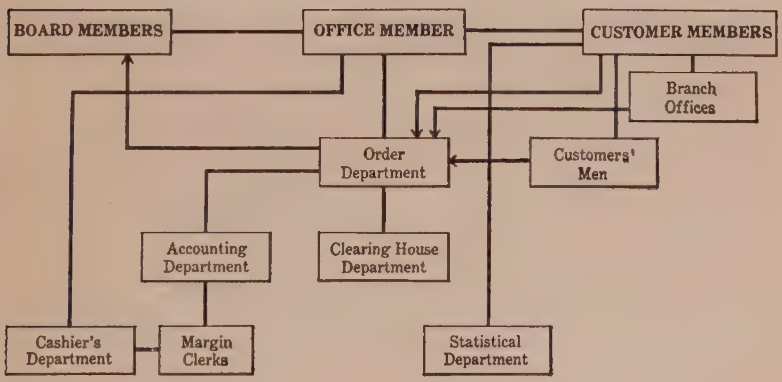
Every firm registered as a member of the New York Stock Exchange must adopt the partnership form of organization in order to insure unlimited liability for the protection of customers.[1] The partnership consists of a group of individuals who contribute varying sums to constitute the initial capital of the business. An important part of the capital goes to buy one or more seats on the New York Stock exchange, and as

[1] The liability of inactive partners may be limited by forming a limited partnership. To gain such limited liability for the special partnership, it must be registered as such. See Gerstenberg, C. W., *Financial Organization and Management*, pp. 49-50.

many other exchanges as the firm decides to do business upon. The rest of the money goes into furniture and fixtures for the brokers' quarters, and into bank accounts, usually in several leading institutions, to facilitate its ordinary business. Owing to the high cost of exchange seats, most brokerage houses now require capital of upward of a million dollars, and several utilize many times that amount.

The organization of a typical stock exchange brokerage house is shown in Fig. 4. The same essential principle of organization is used generally, although individual firms show wide variations in accordance with the peculiar features of their business. It will be seen that brokerage house organization follows functional lines. The several departments may be grouped, according to function, into six divisions:

ORGANIZATION OF A BROKERAGE HOUSE



1. Relations with customers
2. Handling of orders
3. Handling of securities
4. Handling of cash and collateral loans
5. Records
6. Statistical

1. *Relations With Customers.*—This function of the firm is usually under the direction of one or more of the partners. These latter may have special connections with large financial interests or with stock market operators who provide the firm

with a great part of its business. As the cost of executing an order for several thousand shares is not much greater than that of executing one for ten shares, several big accounts may provide the house with the major portion of its profit.

In addition to one or more partners who establish relations with the customers of the firm, the larger brokerage houses have a number of customers' men, the counterpart of the salesman in the investment banking house. The customers' man receives orders to buy and sell securities, by personal call, telephone, telegraph or mail. He may, if he wishes, advise his customers, and the latter, being composed in large part of speculators, are usually quite avid for "tips." The New York Stock Exchange forbids the payment of a commission to customers' men based on the volume of business transacted, in an effort to make the latter a disinterested adviser. But, in fact, records of the business brought in by each customers' man are carefully compiled by most houses, and those that fail to obtain sufficient orders either are dropped or have their salary reduced, while those with a successful record enjoy corresponding increases in remuneration.

The customers' man is an important cog in the stock trading machinery. Through his hands pass the bulk of orders from the smaller investors and traders to buy and sell stocks listed on the big exchanges. Usually only the larger clients deal directly through partners of the firm. If the customers' man's advice is interested, serious loss may ensue. Those wishing to induce public buying of individual issues sometimes try to do so by bringing influence to bear on the customers' man, through giving him what passes as "inside information" and, none too seldom, through permitting him to benefit directly or indirectly from an advance in the price of stock. This can be done by placing a number of shares in his name, although he makes no payment, or by giving him an option to buy the stock at a fixed price, known as a "call." Fortunately for the public, these practices, once rather widespread, are now generally frowned upon by many customers' men and by the members of the firms employing them. In fact, as public knowledge of securities grows, the customers' man tends increasingly to become a mere agent for receiving buying and selling orders, rather than to advise. The advice-giving function is then left to the trained men of the statistical department.

The bulk of the business of the brokerage house is done on a margin basis, although a substantial volume of orders may also be executed on a full-payment or cash basis. A margin account is one in which customers may buy securities with a fractional cash payment, the balance being borrowed from a bank by the broker. Thus, a customer who buys 100 shares of Union Pacific at 200 owes the broker $20,200 for this transaction, including the commission. He may be expected to deposit only 20 per cent of this amount, or $4,040, while a loan is made at the bank for the balance, the loan being secured by the deposit of the stock certificate as collateral.

2. *Handling of Orders.*—Orders received by the customers' men take several forms. They are:

> 1. Market orders: These are executed immediately at the best price obtainable at the time the order reaches the floor of the exchange.
>
> 2. Day orders: Such orders are automatically canceled if not executed during the day in which they are placed, at the price stated. All orders are day orders unless otherwise specified.
>
> 3. Good until countermanded (G.T.C.): Orders of this kind remain valid until either executed at the price stated or canceled by express order of the customer.
>
> 4. Good this week (G.T.W.): Such orders are automatically canceled if not executed by the close of business on Saturday of the week in which the order is placed.
>
> 5. Good this month (G.T.M.): These orders are automatically canceled if not executed by the close of business on the last business day of the month in which the order is placed.
>
> 6. A "stop-loss" order is one which becomes an order to buy or sell at market, as the case may be, as soon as a certain named price has been reached by the stock.

The order department is responsible for keeping files of these various orders up to date, as an error may be costly, and prove a source both of monetary loss to the firm and serious friction with the customer.

The orders are executed by the floor members and the order department. The orders are turned in by the customers' men and through other channels to the order clerks, who send them in by telephone to the floor of the exchange. There the orders are executed and reports of them are immediately telephoned back to the office. A record of each order is then sent to the clearing house department, which arranges the actual transfer of the stock certificates; to the report department, which sends a confirmation to the customer through the mails, and to the accounting department, which makes the necessary entries on the books of the firm. The accounting department, in turn, quickly notifies the margin clerk, whose sole function is to see that the individual accounts of clients are adequately protected by deposit of sufficient cash and securities.

3. *The Physical Handling of Securities.*—This is the work of the clearing house department, so called because the bulk of the work attached to this task has been enormously simplified through the organization of the Stock Clearing Corporation of the stock exchange. The exchange clearing mechanism will be described presently. Attached to this department is a fleet of runners, who carry securities and checks hither and thither in the financial district as the business of the firm requires.

4. *The Handling of Cash.*—The cashier's department is responsible for the handling of cash. By handling receipts and disbursements, the cashier knows at about 2.15 P. M. of each day the approximate money position of the firm, and therefore the amount of new loans needed or the number of loans which can be paid off. Accordingly he, or a subordinate loan clerk, arranges to borrow money, generally using customers' securities as collateral, or to call loans which he is able to pay off, thus reducing the interest charges which the firm must pay. The cashier's department also has jurisdiction over the securities in the possession of the firm, keeping a record of each certificate received and delivered, thus supplementing the work of the clearing house department in the physical handling of securities. The margin clerk is often attached to the cashier's department, and his approval is required before a client can withdraw cash or securities from his account.

5. *The Handling of the Records.*—This is the work of the accounting or bookkeeping department, although in many firms this work is placed within the jurisdiction of the cashier's department. Not only are the accounts of customers and the firm itself kept here, but also the records of payment of interest and dividends on customers' securities, and the accounts of branch offices.

6. *The Statistical Department.*—The statistical department of a large brokerage house does more than the name implies. It not only serves the present customers of the house, but it also seeks to gain new ones through giving service to prospective clients and through advertising.

The direct service given by the statistical department takes many forms. The most characteristic is the market letter, a daily sheet discussing market trends and individual securities. In their efforts to avoid committing themselves as to the actual trend of events, many market letter writers have gained a reputation for proverbial tergiversation. In addition, individual securities in which the brokerage house may or may not have a special interest are described in circulars, booklets and, during trading hours, "flashes." A "flash" is a short statement on an individual stock or group of stocks advising immediate action, and it goes out over the wires to all the offices and correspondents of the house, and at times to its chief clients.

The work of the statistical department is made the basis of the firm's bids for business from new clients. The literature described is sent by mail to selected lists of prospective customers, and to the newspapers for possible quotations. Also, the advertising of most brokerage houses is built around the statistical department, the typical advertisement of many such houses consisting of invitations to inquire for circulars or letters which have been prepared on specific topics or securities of general interest.

The statistical or service department also handles inquiries from clients and others on individual securities. The direct personal service thus given often proves an important builder of new business.

Financing the Brokerage Business

It has been estimated that during the year 1928 alone the value of securities traded in on the New York Stock Exchange was in excess of one hundred billion dollars. The brokerage house must possess a substantial amount of capital to gain the confidence of the banks and thus secure the credit needed for effecting this turnover, and it must also finance the expenses of its own organization.

The average stock exchange house includes three types of partners: floor members, business getters, and moneyed men—the latter to supply the capital. This capital may be in the form of cash or securities. Often only the *use* of securities is contributed, equitable title to the securities remaining with the contributor, who also receives interest and dividends as paid. Whether cash, securities or merely the use of securities is contributed, the result is the same; the firm has working capital with which to facilitate purchases and sales of securities, cover part of the balance due over and above customers' margin in the unusual cases when this is necessary, take positions in stocks and, in many cases, engage in the flotation of new issues from time to time as an investment house.

However wealthy the firm, the capital contributed by the partners is usually only a small fraction of the working capital used in the business. The bulk of the capital comes from loans. New loans are frequently secured in the first instance as a "day loan accommodation" or "clearing loan" from the bank. Checks against this loan are paid out through the day as needed in the firm's business. These advances, sometimes termed over-certifications or note-accommodations, are loans paid the same day they are made. No interest was charged by the banks on such advances until recently, but now one per cent is charged. A brokerage house usually leaves its unsecured note with the bank to cover such advances from day to day as they are made. Such loans are granted by a bank as an accommodation to a brokerage house customer, and in return the brokerage house leaves a fair-sized balance with the bank. For a firm that gets day loan accommodation up to $1,000,000, it is customary to leave an average balance of

$70,000. Very large houses will keep such accounts in several banks.

These accommodation loans are never carried overnight, and are expected to be paid up by 3 o'clock of the day in which they are contracted. By that time, the loan clerk of the firm knows what receipts have come in and therefore how large his overnight requirements are going to be. He can then adjust his collateral loans accordingly. Carrying such loans until 4 o'clock may entail a penalty charge by the bank, such as one day's interest at the full call money rate.

The loan clerk arranges in the afternoon to borrow as much money as is needed to repay the accommodation loan and make any other payments due. Under normal conditions, about one-half of his borrowings will be call loans, and the other half time loans. This will vary, however, according to the interest rate on the two types of loans. The rate on time loans usually is lower than on call loans, and furthermore it is immune, during the period of the loan, from the sharp flurries which characterize the call loan market. On the other hand, a sudden influx may depress the call rate well below the time rate.[1] A fuller description of the collateral loan market will be found below in Chapter X.

The brokerage firm, like the investment house, is free from the necessity of periodically making public its statement of condition and subjecting itself to rigid government regulation, as is the case with commercial banks. Therefore, the public is necessarily in the dark as to the condition of any specific firm, although periodic statements are required of brokers by security commissioners in many states, and by the New York Stock Exchange of its members.

One brokerage house in 1929 broke precedent and sent a statement of its condition to its customers. This statement indicates the large volume of business a broker can do with a relatively small capital of his own. The statement follows:

[1] In times of high interest rates, such as 1928-1929, time loans become of negligible importance because they are not exempt from the operation of the usury law.

Assets

Cash in banks	$ 488,072
Cash on hand	2,253
Deposit with Stock Clearing Corp.	75,000
Memberships	633,500
Customers' debit balances	30,586,603
Securities borrowed	353,900
Securities to deliver	382,108
Unlisted department	270,205
Bank loans receivable	200,000
Dividends receivable	9,587
Commission receivable	25,247
Revenue tax stamps	2,733
Furniture, fixtures and good-will	1
Total	$33,029,209

Liabilities

Capital	$ 2,610,980
Undivided surplus	576,543
Bank loans payable	23,642,000
Customers' credit balances	1,160,572
Customers' short commitments	558,296
Securities loaned	3,044,700
Securities to receive	710,670
Accounts with other brokers	557,586
Commission payable	8,629
Interest	70,778
Reserve	88,455
Total	$33,029,209

It will be noted that the bank loans of the house, together with credit balances due customers and securities loaned to short sellers who turn over cash as collateral, aggregate about eight times the capital and surplus of the broker. It must be borne in mind in connection with statements of this kind, however, that they do not reflect the real position of the firm. The real protection against difficulties lies in the value of the securities held for customers, against which they owe the firm $30,586,603. If this value remains largely in excess of the debit balances of the customers, the position of the house is not endangered even if its own capital is negligible. The size of this margin of excess value depends on the rigidity of the firm's margin requirements.

Sources of Income of the Broker

The brokerage business, like any other business enterprise in a capitalistic order of society, is operated to earn a profit. Brokerage house expenses are large. First, there are the expensive quarters which most of the larger houses maintain in the financial districts of New York and other important cities. Large clerical forces are required to handle the routine, while the partners, outside of a return on their investment, naturally expect to receive substantial compensation for the time spent in the strenuous task of running a securities trading business. Finally, the profit must be sufficient to give an ample rate of return on the capital invested in exchange memberships and the working capital put into the business by the partners.

The income of the broker on the ordinary margin account consists of two elements: commissions, and a differential interest charge. Commissions on the leading exchanges are fixed at uniform rates for all members; deviations are rare, and are generally considered cause for expulsion or fine. On the New York Stock Exchange, the following rates were established in 1923, and have been maintained since:

For Shares Selling at:	*Commission Rate per Share:*
under 50c.	any rate agreed upon
50c.–99c.	3c.
\$ 1–\$ 9.99	7½c.
10– 24.99	12½c.
25– 49.99	15c.
50– 74.99	17½c.
75– 99.99	20c.
100– 199.99	25c.
200 and above	30c. plus 5c. for each \$50 or fraction thereof above \$250 per share

A minimum commission varying from \$1 to \$5 is charged by most brokerage houses for any one transaction. These rates are reduced one-half when business is transacted for other members for their own account, and, as is seen below, to \$2.50 per hundred shares when transacted for other members for the account of customers.

The second source of income for the brokerage house is the interest charged by the broker on the debit balance due from the customer, over and above the amount paid by the broker to the bank. This charge is generally regarded as constituting a service charge by the broker for arranging the loan. Thus, when the average rate for money through the month is 4½ per cent, most brokerage houses will charge their customers on their debt balances from 5 to 5½ per cent, depending on the size of the account. In fact, the broker's "spread" is usually even more, for he is probably borrowing a part of his requirements on a time basis at a lower rate than the average call rate. Furthermore, he pays those customers who have a credit balance a relatively low rate of interest, generally one or two per cent below the average call rate, but such credit balances cut the amount of bank loans he makes. Finally, lending stocks to short sellers may give the broker substantial sums at low interest rates.

Demand collateral loans are exempt from the usury laws in New York and most other states. This exemption does not apply to time loans, however, nor to demand loans of less than $5,000. Therefore time loans become unpopular with lenders after the rate rises above 6 per cent, for the interest cannot be collected at law. Also, a few brokers will not charge more than 6 per cent on debit balances of less than $5,000, despite legal decisions holding such higher charges permissible because the broker borrows in large amounts without regard to specific requirements of individual small accounts.

The New York Stock Exchange insists that the same uniformity exist in interest charges as in commissions, although some differential for the size of the account is allowed in practice. The by-laws of the New York Stock Exchange state that allowing a client a preferential rate of interest for the purpose of getting business is an act against the interest and welfare of the exchange.

The broker's profit on short sales are usually larger than on "long accounts." When stocks are sold short, the proceeds received from the sale are turned over to the broker from whom stock is borrowed, the borrowed stock then being turned over to the purchaser in fulfillment of the sale. Now the lender of the stock usually pays a specified rate of interest on the money he receives as security for the stock loaned. The interest thus paid is retained by the broker who made the short sale, and constitutes clear profit for him, in addition to the commissions received. Furthermore, the broker lending the stock. which belongs as a rule to clients holding it on margin, generally pays less than the market rate of interest for the use of the money, thus cutting the average cost of his funds.

Besides the income from commissions and interest charges, most brokerage houses eke out their profits in a number of ways. Some establish commodity trading departments, others trading departments for over-the-counter securities, acting as dealers and brokers in this important market. A few do a foreign exchange, arbitrage or commercial paper and acceptance business. The majority at one time or another take positions in securities on their own account, or open investment departments where they act as investment bankers in floating new enterprises or bringing out new issues of securities. Many brokerage houses make substantial profits from "making markets" in securities, an operation more fully described in Chapter XX below. Another source of profit that has been tapped lately by many brokers is the establishment of investment trusts, usually in coöperation with other interests. These investment trusts then become important clients of the brokerage house, and thus largely increase its commission business. Besides, the brokers may make large profits from the ownership of the junior securities of the investment trust.

Relation between the Broker and His Client

Owing to the comparatively complex dealings which take place between the broker and his customers, a number of fine legal points have arisen which have resulted in long litigation. The law of the brokerage business has now been largely clarified, so that the relation of the broker to his client can be stated in definite terms.

The broker occupies more than one legal position in his dealings. In fact, four distinct relationships are involved in the handling of the usual brokerage account. These are:

1. The broker as agent, the customer as principal. This is the basic relationship, typical of the brokerage business generally. In executing orders the broker is subject to the usual

liabilities of agents, and in practice, owing to the superior financial responsibility of the broker, he is looked to in case contracts are broken by the customer.

2. The broker as creditor, the customer as debtor. This relationship applies to the unpaid balance of the customer owed on the stocks he may purchase. It will also apply in case of any loss suffered by the customer in his account, as where short sales prove unprofitable.

3. The broker as pledgee, the customer as pledgor. This relationship applies to the stock which, purchased for the customer on margin, is then pledged by him to secure the unpaid balance. The unpaid balance due to the broker from the owner of a margin account actually constitutes a secured debt, with the purchased securities themselves hypothecated as security. In lieu of cash margin, a customer will frequently deposit other securities that he owns, which are also then considered pledged.

4. The broker as trustee, the customer as beneficiary. This relationship applies to stocks and bonds owned by the customer and deposited with the broker when no debt is due to the latter. Frequently customers will have credit balances in their account, or the debit balance due is far less than the value of the deposited securities. It has been held that the broker cannot freely use the customers' securities as collateral for bank loans in such a case, but must consider himself as a fiduciary holding them for the client as beneficiary. Sections 956-957 of the Penal Code define penalties to which the broker subjects himself by illegal pledging of such securities; but a waiver of this provision on a so-called "hypothecation card" is usually required by brokerage houses, to permit them to hypothecate all securities in a margin account, regardless of the debit balance, as the amount owed to the broker by the customer is called.

While the brokerage relationship has these four different aspects, the major one is that of agent and principal. The broker in practice undertakes and agrees to do the following: [1]

1. To buy or sell the stocks indicated by the customer at once.

[1] See Markham *vs.* Jaudon; 41 N. Y. 235, decided in 1869. This is an old but leading case on this subject.

2. To advance all the money required for such purchases beyond the *usual and customary* margin required of the customer.

3. To carry or to hold such stocks for the customers' benefit so long as that usual and customary margin is kept good, or until notice is given by either party that the account be closed.

4. To have within his control and ready for delivery to the customer at all times the shares purchased, or an equal amount of other shares of the same issue within the broker's right of reclamation or possession.

5. To deliver such shares to the customer when required, upon payment of the balance due.

6. To sell such securities upon the order of the customer, and to account to the customer for the proceeds of such sale.

The relationship between the broker and his client is usually put to a test when the latter's account is impaired through an adverse movement in the price of the securities held. When a fall in stock prices impairs the margin of a customer, the broker, to protect himself, calls for an additional deposit of funds. When these are not forthcoming, the broker may, and in fairness to his other clients and the solvency of his house should, place stop-loss orders against the account, at the same time sending the customer notice. The latter step is necessary, as the broker has no right to place such stop-loss orders without specific notice after the customer fails to respond to the margin call. The broker's right to place a stop-loss order is based on the legal principle that an agent with an interest in the subject matter of a contract reserves his right to protect his interest in that contract. It has been held judicially that reasonable notice must be given the customer of the broker's intention to close out his account when the margin deficiency is not made good, for the brokerage relationship constitutes an agency terminable at will.[1]

In the case of a short sale, the broker may buy in the stock sold short immediately when it can no longer be borrowed, for

[1] This notice usually states the securities to be sold, and the time and the place of sale. It is sent by registered mail, with a return receipt required. This sale amounts to a foreclosure on hypothecated property, and the customer is liable for any remaining deficit in his account.

the implied agency contract is then abrogated by impossibility of performance.

Since the broker is primarily an agent, it is best as a rule to restrict his activity accordingly. Discretionary accounts or orders, where the broker is given the right to buy or sell for a client without consulting him, usually lead to dissatisfaction, and most houses and customers' men discourage this practice.

Wire System

Branch banking is practically non-existent in the United States, except in the great cities and in California. In the brokerage business, however, because of the nation-wide dependence upon the market furnished by the New York Stock Exchange, there are a number of chains, either under one control or including several different houses. In 1928, there were more than 1105 branch offices of stock exchange houses, several houses having a dozen and more out-of-town offices, as well as numerous correspondents for whom they execute orders. A small group of the larger houses have as many as fifty branch offices each, including correspondents.

The leased wire system is a remarkable example of mechanical efficiency, and has been developed to a point where the different parts of the country are closely tied in with the major market places, especially New York. The maintenance of this service at a very low cost is made possible through the use of so-called "carrier current," by which a single pair of telephone wires may be used simultaneously for 24 telegraph conversations. This is accomplished through carrying on the telegraph conversations by currents of different frequencies going over the same wires, and separated at each end by a "selecting circuit" device.

Fig. 5 shows the private wire system of a large stock exchange house as it was in 1928, with connections from coast to coast, from Boston to New Orleans, from Los Angeles to Seattle.

The New York Stock Exchange

There has been a great centralization of security trading in the United States. It is of the essence of any good market

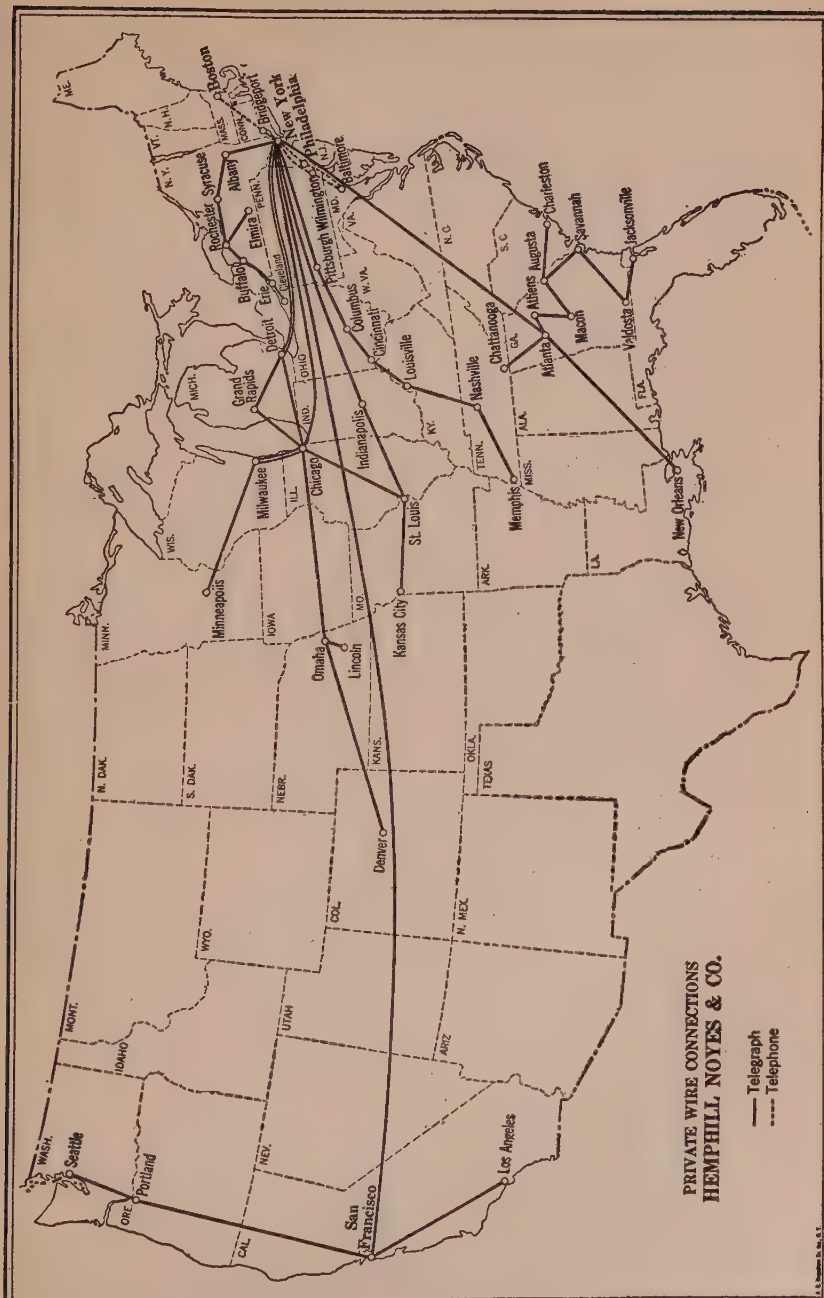


Fig. 5. Wire System of a Large Brokerage House.

that orders from numerous individuals to buy and sell should converge on one trading place, for only then is there reasonable assurance that any individual order can be executed. Although there were 28 recognized stock exchanges in the United States in 1928, with an estimated total of 1,000,000 persons directly dependent upon the security markets for a livelihood, the bulk of the transactions take place on the New York Stock Exchange. It is a prototype for the other security markets, which are modeled along the same lines in their organization and operations.

The New York Stock Exchange is a voluntary association of 1375 individual members. The members may act either as brokers for others or as dealers, but in the case of the great bulk of transactions they adopt the broker relationship. The majority of exchange brokers are so-called "floor members" of commission houses doing a regular brokerage business along the lines described in the first part of this chapter. As only individual members of the exchange are allowed on the floor to engage in trading, firms with extraordinarily large volumes of business, and those whose floor members do not care to spend the day at the grueling task of buying and selling stocks, make use of members who specialize in doing business for others. These are the "two-dollar" brokers, so-called because formerly they received two dollars, and now two dollars fifty cents, for each 100 shares they buy or sell for another stock exchange member.

Two highly important specialized types of exchange members, who may also act as general brokers, are the specialists and the odd-lot brokers. The specialist concentrates his activity on one or a small group of securities, and gets a large number of orders from many sources to buy and sell these issues. Thus he facilitates all transactions and makes a closer market usually than would otherwise be the case. He also frequently trades in these issues as dealer or principal. To avoid an abuse through this concentration of functions, the exchange provides that a specialist cannot act both as broker and dealer in the same transaction. Odd-lot brokers take care of the huge business now transacted on the exchange in lots of less than 100 shares. This business is concentrated in the hands of a few houses, which get odd-lot orders from other member firms. They stand ready to buy or sell odd lots generally at one-eighth or one-quarter point differential from the last reported quotation for a full lot. These houses match buying and selling orders, and often necessarily take positions. An odd-lot house, in order to be in a position to even up its position quickly, has a number of exchange members on the floor at all times.

Activities of the New York Stock Exchange

The stock exchange at the present time consists of a large floor, upon which are twenty-two trading posts, each devoted to dealings in a group of stocks. At these posts the members carry on their trading. Around the room are the telephone stalls, each connected with a broker's office. Large annunciator boards call the members by number to their telephone stalls when necessary to take orders. A separate section is devoted to the bond market.

This physical equipment has proved remarkably expansible. During the decade following the World War, the daily volume of trading in stocks varied from less than 1,000,000 shares to nearly 5,000,000; and while some houses suffered the pinch of inadequate business at one time, and at others were literally swamped with work, the machinery of the exchange itself appeared quite capable of adjusting itself readily to both conditions. The reason for this is that great flexibility is imparted by the specialist, the two-dollar broker and the odd-lot house, and the burden of trading can be shifted to them as conditions indicate. Only in 1929 was the membership of the exchange increased from 1100 to 1375, because of the great expansion in trading volume which had taken place.

In the expansion of the New York Stock Exchange, however, the ticker device for reporting transactions has continually acted as a limiting factor. This device, which in principle is a printing telegraph instrument, was adopted in 1867 for reporting, from the floor of the exchange, the volume and price of each full-lot transaction. Technical improvements have constantly increased its speed, but every improvement merely raises to a limited extent the aggregate number of letters and numbers that can be printed per minute. Inevitably the point is reached where the ticker falls behind the market, causing considerable hardship to traders and defeating the very purpose of the device, which is to give an instantaneous record of transactions completed on the floor of the exchange to every part of the country.

The actual buying and selling of securities involves, as a necessary counterpart, the delivery of these securities from seller to buyer. This is a second huge physical task, one which is taken care of by an organization affiliated with the exchange and known as the Stock Clearing Corporation. The Stock Clearing Corporation makes possible an enormous saving in the number of deliveries of securities and cash that must be made by exchange members as a result of each day's trading, through having each firm deliver to or receive from the Stock Clearing Corporation only those shares and sums due to or from it on balance. A firm which has sold for clients 10,000 shares of General Motors and bought 6,000 shares need only deliver 4,000 to the Stock Clearing Corporation, with the net cash balance due on all the transactions. The Stock Clearing Corporation will then settle with each of the other firms involved in these transactions.

Besides the trading floor and the Stock Clearing Corporation, the machinery of the New York Stock Exchange includes facilities where members can borrow on stocks in connection with margin transactions. In one corner of the exchange floor there is a "money desk," at which offers of call loans from the banks are received, and where members resort when they wish such loans. The supply and demand for this type of loan thus converge at the money desk. As both the bank and the broker in each case prefer to diversify their loans to avoid heavy calls for repayment, such loans are made in units of $100,000 to $500,000. Brokers go to the money desk and apply for loans as offered, while the banks are represented free of charge by brokers who come to the money desk and turn in offers of call loans as received by telephone from the banks. Based on these applications and offers, the banks arrange the individual loans. For the machinery behind the work of the money desk, and the manner in which call loans are renewed from day to day, the reader is referred to Chapter X below, on Investment Banking and the Money Market.

A fourth activity carried on through the agency of the exchange is the loaning of stocks to those who have sold short. The buyer of the security in such a transaction expects his stock to be delivered in the ordinary way before the close of business of the following day. Accordingly, the broker who acts for the short seller must borrow the stock. After the close of the market at 3 P. M., the "stock loan crowd" gathers in one part of the exchange floor, and those who wish to borrow arrange to get their stock from other brokers who are carrying the same shares in long accounts. The lending broker gets the market value of the securities he loans, in cash, as collateral for the stock loan. The usual procedure is here reversed, money being deposited as security for a loan of stock. Interest is usually paid on this money, except where the stock is difficult to borrow. Then the stock is said to loan "flat," and the lender of the stock may have the free use of the money deposited as security, and in extreme cases may also receive a further premium expressed as so many per cent per day, one per cent being $1 per day (the value of the stock being arbitrarily assumed to be $100 a share for this purpose).

The stock exchange is primarily an engine for economizing effort. Like the clearing house in the field of commercial banking, it seeks to settle a multiplicity of transactions in a central place, with a small force, and with a minimum of derangement to the rest of the banking machinery of the country. The huge volume of stock transactions is settled with the use of a comparatively small amount of deposit currency. One study shows that, for the year 1926, a total of approximately $50,000,000,000 of securities was turned over with the daily use of only a little more than $30,000,000 of bank credit.[1] However, the exchange accomplishes far more than does the bank clearing house, for it provides a central market place where securities can be bought and sold, as well as an institution for economically settling such transactions.

Organization and Government of the Exchange

The New York Stock Exchange is managed by a committee of governors, consisting of 40 members elected by the

[1] Rogers, J. H., *Stock Speculation and the Money Market.*

membership of the exchange, and the president and treasurer. The president is the presiding officer both of the exchange and the board of governors.

The board of governors maintains a very rigid control of the members through its disciplining powers, granted by the constitution of the exchange, which contains the general rules according to which it is operated. These disciplining powers include expulsion, suspension or fine, as the case may be, for any "willful violation of the Constitution of the Exchange or of any resolution of the Governing Committee regulating the conduct or business of members, or of any conduct or proceeding inconsistent with just and equitable principles of trade." In less serious cases, suspension up to a period of one year is provided for members adjudged guilty of any act "detrimental to the interest or welfare of the Exchange.

A number of separate activities are carried on by the several committees of the exchange, consisting of from three to fifteen members. There are committees on arbitration, to settle differences between members on contracts executed on the exchange; business conduct, having jurisdiction over customers' accounts; admission, scrutinizing new members; and securities, regulating the delivery of securities in connection with exchange transactions. Other committees have to do with arrangements, commissions and quotations, constitution and finance.

One final standing committee is of great importance in the conduct of the exchange—the Committee on Stock List. This committee of five governors makes recommendations on applications for listing to the governing committee. It has no final power to act itself, though its recommendations are almost invariably followed.

The exchange does not formally take the initiative in listing new securities, but acts only after the companies issuing securities have made formal application. It requires reasonably full information concerning the affairs of the company, and also demands that an annual report be published with income account and balance sheet. The exchange also requests information on the distribution of the securities, insisting on at least 100 holders and in practice expecting many more. Finally, the Committee on Stock List has been guided by a number of special considerations, such as the total amount of the securities outstanding of the corporation, and the stability of the enterprise itself. When the supply of the security is small, the danger of a corner may bring about adverse action on a listing application. The exchange has avoided the listing of most radio stocks and other similar enterprises in their development stage in order to avoid securities, the outlook for which is unusually uncertain. For such issues a period of seasoning on the over-the-counter or curb markets is, as a rule, preferred by the exchange authorities.

Social Functions of the Exchanges

The securities listed on the New York Stock Exchange had a market value of $114,851,081,802 on January 1, 1929. The value of securities listed solely on the other exchanges was estimated at above $10,000,000,000, and about $40,000,000,000 are not listed at all.

A securities exchange, especially when organized along American lines, gives what is generally known as a "public market," because the price at which transactions are made is openly stated, while competition exists in the making of purchases and sales. Where no exchange exists, the individual investor must "shop around" from broker to broker in order to learn fully the condition of the market and thus get the best price available. This he is seldom in a position to do. Hence the exchange, by bringing all bids for and offers of securities to one central market place, gives the individual investor a distinctly greater degree of marketability in most instances, because it relieves him from reliance on one or a few brokers in finding the best bid for his securities.

The chief social functions performed by the exchanges may be summarized as follows:

1. A central market place of numerous buyers and sellers is established for the security, so that its value tends to reflect the judgment of numerous individuals buying or selling it in competition with other securities and with each other.

2. The quality of marketability is imparted to the security, so that it will not generally suffer wide and erratic fluctuations merely because of inability to find buyers or sellers for it at a given moment.

3. The security is made available by this marketability for use as collateral in a loan, thus enabling the investor and especially the speculator to hold it without relying wholly on his own resources.

4. Supervision and publicity for securities are assured. Although exchanges generally seek to interfere as little as possible with the companies whose securities are traded in thereon, they do seek vigorously to prevent out and out frauds. Furthermore, the New York Stock Exchange sets a comparatively high standard in the amount of publicity required from governments and companies whose securities are listed thereon.

5. The exchange acts as a shock absorber in times of panic and impaired confidence. At such a period, when the general tendency is to convert claims into cash, the great need is for a place in which property of any kind may be liquidated quickly. Securities are particularly suitable for this purpose, and for this reason economic crises almost invariably witness exaggerated declines in security prices, but nevertheless this liquid capital often largely alleviates the results of the calamity elsewhere in the business structure.

Other Exchanges and Over-the-counter Markets

Of the twenty-seven other exchanges in this country, the New York Curb Market stands as the leader in size.

The curb had a very informal beginning as an outdoor market, on which stocks not traded in on the New York Stock Exchange were bought and sold. In its day, it practically amounted to an "over-the-counter" market, except that it was brought together in one place. In the course of time, especially during the war, its transactions expanded largely, and many stock exchange houses acquired membership. Finally, the curb moved indoors into a building of its own in 1920, and now constitutes an important auxiliary to the stock exchange. It furnishes a market for a number of mining and miscellaneous securities not seeking admission to the exchange because of inadequate size, highly speculative character, unwillingness to pay high listing fees or unwillingness of the company to disclose the information about its affairs which is demanded by the Committee on Stock List of the large exchange before the listing privilege is accorded. Also, securities for which initial distribution is desired and rights to subscribe to new offerings of stock have a preliminary period of activity on the curb. Finally, the curb has been used in many cases as a market for securities traded in on a "when-issued" basis, when new offerings of stock are made or old issues are split up. In these aspects, the curb acts as the vestibule to the exchange proper.

It was found that the regularly listed securities of the curb failed to use its facilities completely, and as a result an unlisted department has been established, consisting of securities, the listing of which has not been applied for by the company. Any member of the curb may get a security listed by giving a skeleton description of the issue and paying $25 as a listing fee to the exchange. In the daily quotations of the curb market, these quotations appear in the same form as regular transactions. The New York Produce Exchange in 1928 established a securities trading department of an "unlisted" character, thus competing with the business of the over-the-counter dealers.

Most of the other exchanges exist in the larger cities, such as Boston, Chicago, Cincinnati, Philadelphia, San Francisco and Los Angeles.

In addition to those organized exchanges, there is a vast amount of trading carried on by the over-the-counter market. The over-the-counter market is much less organized, and there is no means by which the public may learn of the volume of sales. Through the Unlisted Security Dealers Association, composed of over thirty large New York houses, quotations on bank stocks, insurance stocks and other important groups of over-the-counter issues are made public, giving the bid and asked prices at the close of trading each day.

From the public viewpoint, the over-the-counter market differs from the exchanges in that it is composed chiefly of dealers rather than brokers. This results from the smaller turnover in many such issues and the difficulty of bringing buying and selling orders together at the same time when there is no central market place. The over-the-counter dealer seeks to buy from one client and sell at a higher price to another, the difference being his compensation in lieu of a commission. Because of the relative inactivity and unorganized character of the market, the differential is usually far larger than is the ordinary broker's commission. This difference, usually referred to as the spread between the bid and the asked or offered price, is illustrated in the following typical list of leading New York bank stocks quoted by a dealer specializing in these securities:

NEW YORK BANK STOCKS

	Bid	*Asked*
America	260	270
Bank of the United States	560	570
Bronx National	625	675
Chelsea Exchange	325	335
Central National	200	208
Chase National	597	603
Chemical National	882	890
Continental	390	410
Corn Exchange	660	670
Fifth Avenue	2240	2310
First Avenue	3750	3825
Garfield	575	600
Hanover	1260	1280
Lebanon	190	200
Liberty	230	240
Manhattan Company	610	620
National City	880	890
Public	750	770
State	900	915

For a number of varying reasons, large groups of stocks are traded in almost entirely on the over-the-counter market. Included in these are shares of banks, insurance companies, investment trusts, the smaller chain stores, aëronautical securities, etc.

The Strength of the Brokerage Business

Because of the speculative nature of the transactions which they handle, the business of the brokers has often proved quite hazardous in the past, and public losses through brokerage failures were large at times. Sometimes failure was caused by defaults of customers unable to repay the broker for losses incurred in the event of a break in stock prices so sharp as to more than wipe out margins. In addition, the public lost large sums through trading with dishonest brokerage houses, often called "bucket shops." A "bucket shop" is a brokerage house which does not buy securities as ordered by clients, but pockets the margin deposited and waits for the customer to be wiped out by a decline in the market. They flourish in periods of falling prices, or "bear markets."

The brokerage business today is doubtless in a different position in many respects. Periodic examination by the stock exchange of its members, and regulation of brokers in many states through government officials, have sharply cut down the number of brokers who fail because of dishonest methods of doing business. Failures through financial weakness and the resultant inability to stand moderate losses arising from defaults of customers, have been materially reduced through the mere growth of the business.

The number of brokers has not increased in proportion to the vast multiplication of the volume of transactions, and as a result the average size of brokerage houses has been greatly increased. A survey made early in 1929, for example, revealed a dozen houses on the New York Stock Exchange which enjoyed an average daily turnover of 300,000 shares or more, giving them an income from commissions alone of some $15,000,000 per annum. Naturally these houses can build up a large backlog of financial strength, but, even more important, they find it profitable to turn down weak accounts and insist upon adequate margin protection, for they are not impelled to lower their standards by the need for larger profits.

The result of the sharp increase in the available volume of brokerage business, therefore, has been a general advance in margin requirements. Time was when a broker would accept five per cent margin from a customer, so that his customers were constantly being wiped out and he had to find new groups of clients continually. Now, at times of high prices, brokers demand 30 to 50 per cent in margins. Thus, one leading brokerage house reported in 1929 that it held $350,000,000 of securities for clients, on which only $140,000,0000 was due the banks. Obviously a brokerage house in this situation is in the same position as a strong banking institution, for in the event of any drastic decline in prices it has large unused amounts of customers' securities unpledged which can be sent to the banks as additional margin, giving it a secondary reserve to fall back upon.

As the leading brokerage houses thus gain in strength, the question may be asked as to how much further security trading activities may expand. The answer is indicated by a consideration of the fact that if only 50,000 individuals decide to buy 100 shares of a stock listed on the New York Stock Exchange on one day, the result is a daily turnover of 5,000,000 shares. Hence, as security ownership continues general, and many security buyers purchase stocks on a margin basis, the daily turnover on the exchange may rise in periods of great speculative activity to 10,000,000 shares a day or more, simmering down steadily when speculative enthusiasm disappears. In any event, however, the popularization of security ownership and trading gives a broad field for the broker to expand his business further, and the limitation on the number of brokers provided by exchanges means that the brokerage business is becoming one of the largest and strongest, as far as the leading firms are concerned, in our financial structure.

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Chapter IV

INVESTING INSTITUTIONS

Direct *vs.* Indirect Investment

In the simple investment banking transaction, the investor buys securities directly from a bond house or through a broker from another investor. The burden of choice and the risk of loss rest on him alone.

As the volume of outstanding investment securities has expanded to huge proportions, and the types of issues offered have multiplied many times over, the choice of investments has become increasingly difficult. The investing process at any one moment is to a large extent a matter of comparing values. No matter what the state of business in general or the condition of the securities markets, there are always securities which are "out of line," because their price, compared with other securities, is too high or too low. To appraise individual securities and thus find issues undervalued in the market, and to foresee broad changes in the general level of security prices, are the major functions of investment analysis.

Under these conditions, the investor whose primary personal interest is elsewhere has a strong incentive to use an intermediate institution, placed between himself and the seller of securities, which can adequately perform the tasks of investment analysis. These intermediate institutions, formed for the specific purpose of investing other people's money, have grown to such large proportions that they are now a very important part of the investment banking machinery. Although inclusive figures are not available, the capital which has been invested by them is certainly upward of twenty billions of dollars, and may well be over thirty billions, depending on the classification of investing institutions adopted.

There are three basically different types of investing institutions which have been fully developed in this country. The first of these, typified by the savings bank, operates as an institution of deposit, investing these deposits in securities. A second group of investing institutions issues its own securities and invests the proceeds of their sale. This group, which may be called securities substitution companies, comprises investment trusts, mortgage banks, building and loan associations, and other organizations sometimes loosely described as finance companies. The third type of investing institution, the trust company, manages the funds of each investor individually, giving a special and personal service not possible with the other kinds of investing institutions. Investment counsel firms offer investment advice alone, and fall within this third category.

The oldest and most important type of investing institution, which acts as the intermediary between the capital market and the individual investor, is the mutual savings bank. This type of institution now controls the placement of about ten billions of dollars. In addition, commercial banks have in recent years developed a large volume of savings deposits, which have been invested in securities in much the same way that the savings bank has followed, although with far less legal restriction.

The savings bank and commercial bank are both hedged about by legal restrictions as to their investments, resulting in a relatively low rate of return to their depositors. The wishes of investors for larger returns are met by the investment trusts, which have been developed extensively since the World War. Land banks, building and loan associations and other institutions designed specially for financing the farmer and urban real estate development have also absorbed increasing amounts of capital, but, because of the numerous peculiarities of mortgage banking, they will be studied separately in Chapter VI. The trust company, and the commercial bank with a trust department, now control the investment of upward of \$15,000,000,000, and these fiduciary companies are also steadily expanding the volume of their business.

In this chapter, the organization of these investing institutions and the legal and economic aspects of their work are studied. Also, some appraisal of their activities is made from the point of view of the investor. A fuller discussion of their investment management policies is contained in Chapter XXI.

The Mutual Savings Bank

The mutual savings bank is the original prototype of the conservative intermediate investing institution. From ancient times organizations have existed which sought to invest money for others, but at best these were often merely deposit agencies, and at their worst, like the John Law scheme tried out in France in the eighteenth century, they were based on fanciful projects or outright fraud.

The mutual savings bank movement had its root in charitable and benevolent organizations formed to promote thrift among the wage-earning classes. It was not originally a business enterprise, in the usual sense of the word, and for the most part the profit-making motive has been, at least nominally, left out of mutual savings bank operation. Often, however, this has led to the organization's becoming somewhat of an anachronism in the modern financial structure, for as it grows in size and its depositors in wealth, the old charitable and benevolent characteristics are no longer needed.

Instances of mutual savings bank organizations were found in Germany in the latter half of the eighteenth century. In Scotland, such a bank was first established in 1810. The idea spread rapidly, and in 1816 such institutions were proposed in Boston and New York. During the next few years, savings banks were chartered in most of the important towns in New England and the Atlantic states.

The mutual savings bank, as an intermediate investing institution, possesses a number of important features which give it a distinct character. This character has largely been preserved through the years, although in modified form, because of rigid legal regulation and the extreme conservatism of legislators in changing savings bank laws, on account of the feeling which prevailed that here was the basis of the thrift of the poorer classes, needing ultra-conservative management and iron-bound safeguards. The peculiar features of the mutual savings bank are the following:

1. It is a mutual institution.

2. It is supposed to be non-commercial in character.

3. Its investments are rigidly determined by law.

Each of these characteristics will be considered in turn.

1. The mutual savings bank is a non-stock institution, so that its assets are in effect the property of depositors. The sole exceptions are moderate initial guaranty and expense funds, which are returned to the trustees who advance them after the bank has been fully established. Earnings of the bank on its investments are similarly the property of depositors, after expenses have been deducted. The bulk of the income is paid out, *after it is earned,* as a stated rate of interest. The rest goes into a reserve fund, or surplus, which assures permanent strength and stability to the institution. This further protects depositors against loss, and permits the payment of a higher interest rate in course of time.

2. The savings bank is supposed to be a benevolent institution, and therefore non-profit making. In a leading case on savings banks, the New York court stated:

> Savings banks are not organized as business enterprises. They have no stockholders, and are not to engage in speculation, or money-making in a business sense. They are simply to take the deposits, usually small, which are offered, aggregate them and keep and invest them safely, paying such interest to the depositors as is thus made, after deducting expenses, and paying the principal on demand.[1]

The non-commercial aspect applies both to the mutual savings bank itself and to its managing body. The trustees in some states are permitted no fee whatsoever for their services. Elsewhere they are allowed only "what is just and reasonable" for actual services performed. Also, no loans may be made to directors, and provisions exist for restricting, although not always with success, indirect gain that may come to officers and trustees from connection with the bank.

3. In the operation of the savings bank, safety of the principal of depositors is made the first consideration. Accordingly, the individual states where mutual savings banks operate have passed laws governing their investments, usually within very narrow limits. Many of these laws were passed a long time ago, and have been changed very reluctantly since, so

[1] Hun *vs.* Carey, 82 N. Y. 65, decided in 1880.

that they often appear out-of-date in the light of present-day conditions and knowledge of investment matters.

The mutual savings bank, as described above, is the original and typical form of savings bank. In the South and West, however, it has made practically no headway, and in the East it has met in later years with increasing competition from other less restricted types of intermediate investing institutions which are described later in this chapter. The stock savings bank, run on a commercial basis, is common in California, Iowa and several other states.

Organization and Operation of the Mutual Savings Bank

A mutual savings bank may be formed under the laws of eighteen states at the present time. More than 90 per cent of these banks, however, are actually located in New England, New York, New Jersey and Pennsylvania, and those outside the states mentioned are of small size for the most part. Hence, the mutual savings bank as an investment banking institution may be considered as of sectional importance only.

Under the laws of these states, mutual savings banks may be organized by individuals willing to assume the burden of becoming trustees. The trustees are a self-perpetuating body in whom rests the management of the institution. The office of trustee is presumably sought only for the honor thereof, and as a result the liability of the trustee is limited to gross neglect of duty or violations of the law. In practice, however, other motives besides those of honor and prestige do admittedly operate, and generally without adverse effects upon the value of the institution. Those who can, directly or indirectly, benefit from starting a mutual savings bank are the following:

1. Investment bankers, who can then place before the other trustees the advantages of buying certain of their particular issues. In practice, investment bankers have not played an important rôle in savings banking, however.

2. Lawyers, who receive a great deal of business from savings banks, especially in the searching of titles of real estate which constitutes security for mortgage loans. The Attorney-General of New York State has held that this is legal business

for a trustee to perform, provided payment of the fee comes from the borrower and not from the savings bank itself.

3. Commercial bankers, who have a great interest in getting savings bank accounts. Savings banks often keep 10 per cent and more of their funds on deposit with commercial banks to meet current demands for cash and to await satisfactory investment opportunities. From the viewpoint of the commercial bank, such deposits constitute excellent business.

4. Officials of title guaranty companies, who similarly seek savings bank business, and thus those interested in such concerns are not averse to furthering savings bank activities. In Massachusetts, where savings banks may now solicit life insurance, the same reasoning applies to insurance officials.

5. Salaried officials of savings banks who are interested in the growth of the banks, so that their remuneration may not only be maintained but increased with the growing volume of deposits of the bank.

Deposits made with savings banks belong in the category of time deposits. The bank may demand notice of withdrawal of funds, ranging from two weeks to three months. This is on the theory that the funds are placed in permanent investments, so that day-to-day liquidity need not be maintained. The legal provision limiting the size of individual deposits is similarly designed to prevent large individual depositors from jeopardizing the investment program of the bank through sudden withdrawals of substantial sums. As a result of these safeguards against large and sudden withdrawals, no legal reserve requirements exist for mutual savings institutions. The deposit is evidenced by a pass book, which possesses more than the ordinary bank-book significance, since withdrawals are made as a rule only on presentation of this pass book. The pass book is sometimes used as security for loans.

The savings bank is peculiar among investing institutions in that the depositor is not dependent upon the marketability factor. He is entitled at all times, subject to the notice just mentioned, to withdraw his principal and accumulated interest. His savings, as long as the bank is solvent, and mutual savings bank history reveals almost no real failures, are thus completely under his control.

The investments of a mutual savings bank are rigidly regulated by law. The general trend of these laws is to limit investment to real estate mortgages, government and municipal bonds, and a limited group of the better railroad and utility bonds. Stocks are not permitted as investments in any important savings bank state.

The effect of these investment restrictions upon the value of the mutual savings bank to its depositors is twofold. In the first place, it cannot achieve full diversification in its investment portfolio, for it is limited to fixed-income-bearing securities, and any general factors which adversely affect such securities, such as rising interest rates, will impair the value of the bank as an investing institution to its depositors.[1] Secondly, by limiting these banks to a relatively small and fixed number of investments, the market prices of the securities which pass the test and thus become "legal investments" are raised relative to other equally good but non-legal securities. As a result, it has become increasingly difficult for these institutions to pay a reasonable rate of interest, and depositors are restricted to a lower return than would otherwise be the case. On the other hand, the limitation of investment to a restricted group of "legal" securities results generally in marked price stability for them, since, regardless of investment conditions as a whole, there is always a substantial demand for these "legals."

The investments of the 618 existing mutual savings banks on June 30, 1927, were reported as follows by the Comptroller of the Currency:

Loans (mainly real estate)	$5,064,595,000.
U. S. Government Securities	220,841,000.
State, County and Municipal Securities	458,015,000.
Railroad Bonds	652,014,000.
Public Utility Bonds	374,937,000.
Miscellaneous	1,817,543,000.
Total	$8,587,945,000.

[1] The depositor in the mutual savings bank has one advantage over the direct investor in gilt-edge securities, in that his principal, expressed in dollars, is not impaired by a rise in interest rates and a consequent general drop in bond prices. The savings bank's surplus protects the depositor against adverse effects from this contingency.

The periodical payment made by the savings bank out of its net earnings is erroneously termed interest. It is strictly a dividend, which is contingent upon earnings; and in many states, such as New York, no fixed rate can even be promised in advance. Interest on invested deposits and on the invested surplus of the bank is the source of these earnings, but the accumulated surplus itself is seldom used to meet current dividend payments. As a rule, it is found that annual expenses amount to about 1 per cent on the deposits of the institution. Hence, when 5 per cent is earned on the portfolio, 4 per cent may be paid as interest. Where a large surplus exists, earnings on it may be sufficient for expenses, so that all earnings on the invested deposits may be paid out; a number of mutual savings banks are in that position at the present time.

Development and Future of Savings Banks

The growth of mutual savings banks in recent years is shown in the following table:

Year	Number of banks	Deposits[a]	Number of depositors	Average deposit
1914	634	$3,915,555	8,277,359	$473.04
1920	620	5,186,952	9,445,327	549.16
1924	613	6,693,246	10,409,776	642.98
1925	611	7,146,951	10,616,215	673.21
1926	620	7,577,504	11,053,886	685.51
1927	618	8,077,099	11,337,398	712.43
1928	616	8,672,823	11,732,080	739.24

[a] *000* omitted.

In view of the enormous expansion of investment activities in this country in recent years, especially in the territory in which the mutual savings bank is most prominent, it is evident that this institution has not kept pace and is not doing so. The reason is that the increase in average individual wealth and the steady spread of knowledge concerning investments have largely reduced the need for a purely benevolent type of institution, while making the development of efficient, reliable investing organizations, run on business lines and unhampered by obsolete legal restrictions, a greater need than ever before. Accordingly, the savings bank has difficulty in holding its own, relatively, as other investment institutions, operated according to broader investment principles, come into being. Nevertheless, the interests behind the existing savings banks are steadily responding to the omnipresent commercial impulse, being guided by the same motives which were described above as often operating to induce individuals to start new savings banks. Years ago, a court in New York held that "it is not legitimate for the trustees of such a bank to seek depositors at the expense of present depositors. It is their business to take deposits when offered." Now, savings banks in many cases do not hesitate to use a very small proportion of their income for publicity and advertising purposes to increase their size by securing new deposits. At the same time, they have increased their importance also through resort to such thrift-building activities as school savings accounts, Christmas clubs, etc. Lastly, a tendency toward some moderate liberalization of investment provisions has been noticeable in recent years.

The stock savings bank has revealed a similar tendency to slower growth, as may be seen from the following table showing its development:

Year	Number of institutions	Deposits[a]	Number of depositors	Average deposit
1914..........	1,466	$1,018,330	2,832,140	$473.04
1920..........	1,087	1,351,242	1,982,229	681.68
1922..........	1,066	1,401,742	2,883,136	486.19
1924..........	990	1,746,609	3,562,017	490.34
1926..........	904	2,021,614	4,107,913	492.13
1928..........	791	1,561,561	3,273,162	477.08

[a] *000* omitted.

Because of their location in agricultural areas for the most part, by far the larger portion of their resources is in farm mortgages.

The United States government was long importuned to establish a government savings bank along the lines of the European government savings institutions. The postal savings system was finally established by Act of Congress in 1910, but its efficacy as a competitor of private savings institutions was practically eliminated by the establishment of a 2-per-cent interest rate. Offices of the postal savings system are established in many post offices throughout the country, and on June 30, 1927, deposits amounted to $147,359,254. The low interest rate precludes the postal savings system from ever becoming an important factor in the investment banking organization of the nation. This, apparently, is in accord with the theory that the government is in the savings bank business not to compete with existing institutions, but to supplement them by attracting the savings of the immigrant classes who have brought with them from abroad a suspicion of privately owned banking institutions. With the cutting off of immigration, this factor is naturally of decreasing importance in the investment banking scheme of the nation.

The most important expansion of savings banking in recent years has arisen from the establishment of savings departments by commercial banks, and a consideration of this institution is given in the following section.

Savings Departments of Commercial Banks

Commercial banks have long sought time deposits.[1] In fact, in certain parts of the country where business opportunities were few, commercial banks and trust companies have long acted in practice primarily as savings banks for their communities. However, the large banks did not actively solicit savings deposits as such until recent years.

The way was opened for the general entry of the large banks into the savings business when the Comptroller of the Currency, in 1903, ruled that "there does not appear to be anything in the National Bank Act which authorizes or pro-

[1] Formerly such deposits were handled in a special manner, being evidenced by certificates of deposit. Now commercial banks in their savings departments more nearly approximate the practices of the mutual savings banks, with passbooks to record deposits made.

hibits the operation of a savings department by a national bank." The development of savings banking by commercial banks on a permanent basis required permission to purchase securities as well, and this was granted similarly in a ruling of the Comptroller of the Currency under Section 5136 of the Revised Statutes of the United States, which permits a national bank to discount and negotiate promissory notes, drafts, bills of exchange, *and other evidences of debt.* The Federal Reserve Act recognized the savings deposit, and required a reserve of only 5, afterwards changed to 3, per cent against such time deposits. The McFadden Act of 1927 further provided for them by recognizing bond investments in more explicit terms, stating that "the business of buying and selling investment securities shall hereafter be limited to buying and selling without recourse marketable obligations evidencing indebtedness . . . in the form of bonds, notes or debentures commonly known as investment securities, under such further definition of the term 'investment securities' as may by regulation be prescribed by the Comptroller of the Currency." The Comptroller has subsequently ruled on this matter as follows:

> Under ordinary circumstances, the term "marketable" means that the security in question has such a market as to render sales at intrinsic values readily possible.
>
> In classifying a given security as marketable, the Comptroller of the Currency may in specific cases give consideration to various facts and circumstances, but he will require in all cases the following:
>
> (a) That the issue be of a sufficiently large total to make marketability possible.
>
> (b) Such a public distribution of the securities must have been provided for or made in a manner to protect or insure the marketability of the issue.
>
> (c) That the trust agreement under which the security is issued provides for a trustee independent of the obligor and in the case of securities issued under a trust agreement executed and delivered after sixty days from the date of the promulgation of these regulations, such a trustee must be a bank or trust company.

The growth of time deposits in commercial banks and trust companies is summarized in the following table (in millions of dollars):

Year	*Time Deposits*	*Percentage of Total Deposits*
1922..........	$6,129	20.46
1925..........	11,826	31.37
1926..........	14,826	33.72
1927..........	16,815	41.70
1928..........	18,197	42.42

The commercial banks have shown a more rapid increase in time deposits than have the mutual savings banks. A segregation of assets of savings departments of commercial banks, on the ground that otherwise the investment of such funds is inadequately unregulated, has often been advocated. The present situation in effect permits the commercial bank to solicit deposits on the same basis as a savings bank, and to invest such funds in any fashion in which it would invest its ordinary demand deposits, including the purchase of any marketable bonds. However, it has been shown that a large proportion of the time deposits do not represent individual savings, but rather large deposits of corporations and business men who keep funds this way in order to get a higher rate of interest. A time deposit is one which cannot be withdrawn without 30 days' prior notice, when demanded, and thus is not subject to check. Under these circumstances, it is difficult to see where the line of segregation would be drawn.[1]

National banks are required to report savings deposits separately to the Comptroller of the Currency. On June 30, 1927, they reported a total of $5,875,670,000 in savings deposits, compared with $7,315,624,000 in time deposits on that date. The extent to which national banks have become savings institutions also is shown by the fact that, out of 7,796 national banks operating on that date, 6,548 reported savings deposits and 4,600 had separate savings departments. The aggregate number of savings depositors was 14,340,687, indicating an average deposit of $409.

[1] See a discussion of "Bank Expansion versus Savings," by Benjamin M. Anderson, Jr., in *The Chase Economic Bulletin*, vol. viii, no. 2, June 25, 1928.

The Investment Trust

The essential feature of the savings bank is the reasonably absolute security of principal achieved by restricting investment to ultra-conservative fixed-interest-bearing investments. As the field of investment has broadened, and numerous sound and profitable opportunities for investment have developed elsewhere, other intermediate investing institutions have arisen, designed to invest other people's money without the narrow restrictions typical of the savings bank. These other investing institutions for the most part stress a larger income or appreciation of principal, rather than merely absolute security of principal with a moderate limited rate of return.

Where these intermediate investing institutions combine management with investment functions, they are generally referred to as holding companies, and such concerns have played an important rôle in the consolidation of American industrial and public utility enterprises. However, our primary concern here is with the purely investment intermediaries, generally termed investment trusts.

An investment trust may be defined as an institution which combines and manages the funds of numerous investors, operating without legal restriction as to the securities it may purchase. Although numerous types of investment trusts have lately been evolved in this country, the prototype of the investment trust was developed in Great Britain in the latter part of the nineteenth century, at a time when investment became a popularized activity there.

The British investment trust at first operated along speculative lines, but the debacle attending the Baring failure of 1890 brought about a drastic change in policy, accompanied by an almost universal scaling down of capitalization. As a result of the experience of that period, the British investment trust movement adopted a conservative code of practice, including in most cases the placing of realized profits on investments sold in reserve accounts, to offset actual or possible losses on other security holdings. Further, the British trusts have tended to restrict dividend payments on their shares to actual interest and dividend receipts on the securities held in the portfolio. Furthermore, most of these trusts learned to diversify their holdings carefully, both as regards a balance between stocks and bonds and in the geographical distribution of their investments. They increased their income chiefly by purchasing high-yielding foreign securities. More speculative operations, including extensive trading and purchase of control of concerns, are left mainly for a distinct category of enterprises known as "finance companies," which more nearly approach our financial holding companies in character.

Several other features characterize current British investment trust operation. Most trusts aim to reduce their operating expenses as far as possible, through the obtaining of expert boards of directors and through the maintenance of the same statistical organization by a number of trusts, resulting in the formation of several group organizations. Furthermore, they follow a policy of full publicity, a majority of them making public periodically a list of their holdings. Finally, they trade on the equity to a large extent, issuing bonds and two or more classes of stock, thus increasing the returns on the junior security to a high rate when earnings are satisfactory, while placing the senior securities in a strong, protected position.

The investment trust was practically unknown in the United States until after 1920, although a few such investment organizations did grow up here and there. Two factors then appeared to make the investment trust a common institution. In the first place, an enormous rise in security values got under way about 1922, and for years thereafter went forward at a steadily accelerated pace. This gave the general public confidence in security investment, and also created numerous speculative opportunities which investment trusts were in a position to take advantage of. The large returns many of them were thus able to secure soon captivated the public imagination, and a veritable swarm of such organizations of various kinds and varying quality resulted. In the second place, the prostration of most capital markets abroad after the Great War created similar opportunities there, while the lack of prosperity in these countries kept their markets relatively low after the prices of securities here were lifted far above what anyone could call a "bargain level." As in England, the individual investor frequently preferred to intrust his funds for investment abroad to those who specialized in investment matters, rather than to buy directly securities of foreign governments or corporations.

The investment trust offers the investor two chief advantages: diversification of his holdings and expert management. For these advantages, the investment trust mechanism exacts a twofold tribute from investors: the original selling cost or "loading" and other benefits to the organizers, which must be deducted from the fund of the investor, and the expenses of administering the trust, including the share in the income which, in one form or another, goes to the management. The investor is supposed to receive something for which he pays. The investment trust, unlike the mutual savings bank, admittedly is run on a straight business basis.

The rapid evolution of the investment trust in this country after 1920 resulted in an early departure from the British model, and the development of several different forms of investment trust organizations. The four more important types developed were the general management, the specialized management, the fixed trust and the financial holding company, and these will be discussed separately. The relative importance of each type in January, 1929, is indicated by the following compilation:[1]

	Number	*Paid-in Capital*
General management	119	$781,000,000
Specialized management	32	136,000,000
Fixed	21	58,000,000
Financial holding companies	26	550,000,000
Total	198	$1,525,000,000

The General Management, Discretionary or "British-type" Trust

This type comes nearest to the original English prototype, and most American trusts, especially the earlier ones, were frankly efforts to imitate what had been done abroad.

[1] Made by Leland Rex Robinson. The financial holding company group excludes pure holding companies. During 1929, about $2,000,000,000 more was absorbed, chiefly by general management and financial holding companies.

The general management investment trust is usually organized as a corporation, although in a few cases the legal form of organization adopted is that of a business trust. In practice, however, this generally proves a formalistic rather than an essential difference. Most of these organizations indulge in what is known as "trading on the equity," issuing bonds, preferred stock and common stock. When earnings are large, the balance of income left after deducting interest and preferred stock dividends may give a really phenomenal rate of return on the junior shares; the rise in security prices after the war permitted investment trusts to make a remarkably successful record in the early years of their history. The bonds and preferred stocks are meant to appeal to more conservative investors, but such issues often acquire speculative characteristics through being made convertible into common stock, or having attached to them warrants to buy common stock at fixed prices. In January, 1929, the following analysis of capitalization was issued covering 146 investment trusts of this general type, in terms of paid-in capital:[1]

	Amount	*Per Cent*
Bonds and debentures	$200,000,000	20.5
Preferred stock	439,000,000	45.0
Common stock	337,000,000	34.5
Total	$976,000,000	100.0

The securities of a general management investment trust are generally distributed on different bases to the general public and the management group. The general public, in the usual instance, subscribes for all or the bulk of the senior securities, while the management receives most of the junior shares, thus retaining control. In most cases the management makes some payment for these junior shares, although instances abound where it acquires them free of cost, in return for the services of promoting and managing the trust.

The management of the trust is usually allowed to purchase and sell securities for investment at will, subject only to such general restrictions as the limitation of the percentage of re-

[1] From data compiled by Leland Rex Robinson, published in the New York *Journal of Commerce*.

sources that may be placed in one security or type of issue, or in one foreign country. It can thus operate for profits on turnover as well as interest and dividend income on investments, seeking security bargains in all countries and disposing of these issues when quotations rise to a point where better opportunities may be found elsewhere. By maintaining a statistical organization, of an elaborate nature at times, the management can be on the *qui vive* for opportunities in every industry and in every part of the globe. It can liquidate when security prices rise too high because of general speculative enthusiasm, and buy heavily when prices seem unduly depressed. It not only can help the small investor to avoid putting all his eggs in one basket, but it can see that the investor has most of his eggs in the right baskets.

The accounting practice of American investment trusts differs radically from that of the British prototypes, and profoundly affects the character of their operations. When security prices rise, income from turnover becomes a very important part—often the major portion—of investment trust earnings here. The usual British practice is to include in the trust's income for the year only interest and dividends received on securities in the portfolio, while trading profits go into a reserve account which protects the trust against future depreciation in the value of its investments. Only when profits have accumulated to a large sum over a period of years is any benefit passed on to shareholders in the form of a stock dividend. The American practice is diametrically opposite to this. The trusts here report income from both sources as current earnings, available for dividend payments. During a sustained period of rising security prices, the earnings reported one year from profits taken on securities sold could probably be maintained the following year by further sales. But during a general decline in security prices, the earning power reported in the year of many profits may prove wholly illusory in the following period. The British trusts learned to put profits directly into reserves and thus make them unavailable for current dividends, as a result of their sad experiences of the 'nineties of the last century. The wisdom of this policy was confirmed during the war, when security prices were sharply depressed generally. Presumably, similar results may follow here, unless American investment trust managements prove exceptionally able in constantly finding investments that appreciate. Under the present system, there is a strong temptation to maintain total earnings by selling out the better part of the portfolio each year to show turnover profits, while retaining the less desirable securities.

The general management investment trusts fall into two broad groups as regards management, one of which includes trusts which are affiliated with investment houses, and the other, trusts which may lay claim to an independent status. Trusts affiliated with investment banking houses enjoy the advantage of being allowed to participate with the latter in their underwriting transactions, getting the full benefit of the underwriting syndicate's profit. The cost of distribution of their securities is reduced in many instances. They also enjoy the benefit of the statistical and other information possessed by the investment banking house, which may permit them to avoid the burden of overhead expense entailed in the maintenance of a separate statistical organization. To offset these gains, however, there is the presumptive suspicion that the judgment exercised in making the investments may be warped by the interests of the banking house. In certain cases, the publication of the list of security holdings of such a trust shows that in it were placed securities which the investment house found it difficult to dispose of elsewhere.

As a matter of fact, most investment trusts are now very closely affiliated with investment banking and brokerage houses, and very few of these are without such connections. An affiliated investment trust permits a substantial expansion of the activities of the investment banker, by largely increasing the volume of funds whose disposal he controls.

As practice becomes standardized, a growing number of these general management investment trusts are raising their standards of operation, including the extent to which they make their affairs public. A great number of British investment trusts make their holdings public periodically. In the beginning, hardly any American trusts did so; but when a "whispering campaign" was directed against several of them, especially those connected with investment banking houses whose underwriting record was not good, they were compelled to drop the veil of secrecy. In no case has it been alleged so far that the publication of the holdings has adversely affected the position of the trust; on the contrary, it has made for greater public confidence in such organizations. The New York Stock Exchange insists upon such publication before it lists investment trust issues.

A modification of the general management type of investment trust which has achieved a moderate importance is the investment fund. The basic idea is the aggregation of the funds of a number of investors, which are then invested by the management, subject only to general restrictions. Investors may withdraw their funds whenever they wish on giving specified notice, at which time they will receive their principal and undistributed earnings, less certain moderate deductions. This withdrawal feature gives to the investor in the fund some measure of independence of the marketability feature. However, unlike the depositor in the mutual savings bank, what he gets on withdrawal is not always the total principal of his investment, for if the fund has suffered losses these are first deducted. In the case of an accumulative fund, holders of certificates in the fund receive no current income, all earnings being reinvested to increase the principal.

The investment fund appeals chiefly to the wealthier investor. It aims at providing the dual advantages of expert management and diversification, without the trading on the equity. Also, it gives the investor automatic liquidity by permitting him to withdraw at will. The management fee is usually a stated percentage of the capital, such as one-half of one per cent per annum.

Specialized Management Trusts

The specialized management investment trust restricts its operation to a specifically delimited field. Most of them, in fact, operate in the banking, insurance, mining and aviation industries. The thought behind their organization is that certain fields of financial and business activity offer superior investment possibilities for investors who are willing to intrust their funds to the management of a group of men expert in such fields. These experts can then pick out the most desirable securities available there, and trade in and out of them as circumstances may dictate. Furthermore, in the fields of banking and insurance, prices of the individual shares are often so high that diversification becomes unusually difficult without an intermediate investment organization which pools the funds of many individuals.

In view of the success of this type of investment trust in the aviation field, it is likely that it will assume an important rôle in the future in the financing of new industries in this country. Within such new industries changes are often very rapid, and companies which at one stage of development appear to be very promising may be out of existence a few years later. The usual kind of financial expert may be powerless to analyze such securities intelligently, at least without the aid of technical experts who have a thorough knowledge of the industry. A specialized management trust run by technical men and bankers here has an especially broad opportunity.

The Fixed, Non-discretionary or Bankers' Share Trust

In the pure type of fixed trust, the investors' funds are placed in a named list of securities, chosen once and for all at the inception of the trust. Against this list of securities, collateral shares are issued representing fractional ownership, usually in low denomination. The investor thus gains diversification, but the act of management takes place only at the start.

The theory behind the pure fixed trust is that a picked group of leading companies, taken together, should show a steady increase in the value of their equities, regardless of economic, industrial and financial changes. Hence, shares in a fixed trust are offered at all times, regardless of the state of the security markets or the condition of business. Whereas the general management investment trust sells many of its holdings and keeps its funds liquid when general declines in quotations are anticipated, the fixed trust remains undisturbed. It ignores the possibility of great temporary fluctuations in security prices caused by abnormal conditions which may develop in general business, the credit structure or the money market, and instead invites the investor to look only on the long, upward secular movement of prices of shares in the leading corporations.

Such fixed trusts may operate either in the general run of securities, or in certain specified groups, such as oil stocks or bank stocks. In either case, the trust shares represent as a rule a deposit of collateral with a trust company; and investors who so wish may, by securing a sufficient number of shares, turn them in to the trust company and get the deposited collateral. Thus, if a trust is formed in 30 named stocks, which together cost $10,000, 1,000 certificates may be sold against them, and the trust company will agree to turn over this collateral at any time against the offer of that number of certificates.

The shares in a fixed trust are generally sold by a sales company formed by the management for the purpose of distribution. The price of the fixed trust shares to the public includes a varying surcharge covering selling, trustee and other expense. This surcharge probably averages in excess of 10 per cent, and has been as high as 20 per cent in individual instances. In the case cited, where 1,000 certificates are issued against stocks having a value of $10,000, each certificate would be sold to the public for $11 where a surcharge of 10 per cent is desired.

There are few pure fixed trusts in operation, most such organizations allowing the management some discretion. Thus, several of them permit a shift of the funds of the trust out of any security held which appears to the management to become a poor commitment in the course of time, into call loans, government bonds or securities on a named reserve list. Others operating within special industries, like bank stock trusts, permit the substitution of any other bank stock for one on the list which appears to become over-priced, or for some other reason becomes undesirable. In such cases, the fixed trust approaches the specialized management trust in character.

A number of general advantages are claimed for the fixed trust, to offset the differential between the price paid for the certificates by the investors and the market value of the underlying collateral. The greatest is the low price of the certificate, usually between $10 and $30. Then there are conveniences in income payments, which are remitted regularly by the trustee, and certain savings and conveniences in inheritance taxation, since it is not necessary to secure the transfer of any underlying securities in case of the demise of the holder.

Financial Holding Companies

A large number of investing organizations have grown up in recent years which combine with the pure investment function a certain degree of control and management. This places them midway between the investment trust and that much older form of organization so common in this country, the holding company. As most of these organizations exercise control of other financial institutions, such as commercial banks, insurance companies or other investment trusts, they are generally termed financial holding companies. Several such organizations have attained great size, so that they stand out among the most conspicuous financial organizations of the time, both in this country and abroad. The financial holding company is the most ubiquitous type of investment trust, being organized under the name of "holding," "omnium" or trust in England, France, Belgium, Germany, Switzerland and Austria.

The combination of investment with control of enterprises in which investments are made is logical, as these companies grow in size. They differ from the usual holding companies in the broad scope of their interests, and in their willingness to buy control, build up a company and then in certain instances sell out the control to others, freeing their funds for other similar ventures. Among the largest such organizations are the Transamerica Corporation, owning branch banking chains in California and New York City and a diversified portfolio of general securities in addition, as well as investment banking organizations of the middleman type. Others are the Goldman Sachs Trading & Financial Corporation and Selected Industries, Inc., the latter specializing in the industrial field. The Alleghany Corporation, sponsored by the Van Sweringen interests of Cleveland and J. P. Morgan & Company, is applying the same principles of operations to the railroad field.

Finance companies operating along these lines have been formed also by a number of banks and investment houses.

They do not as a rule engage in all the varied lines of activities into which the largest companies have entered; but most of them act as general management investment trusts and, at the same time, in an underwriting capacity for new security issues, carrying on special financing transactions not found suitable by the commercial bank or investment house affiliated with the finance company.

The Trust Company

The trust company differs from other investing institutions in that it offers individual and personal service, both during the life and after the death of the investor. For the most part, the trust company necessarily appeals to the individual of relatively large means, although as the volume of business has grown it has become profitable to handle accounts even as small as a few thousand dollars.

The trust company has enjoyed its greatest growth in this country, where it has had more than a century of development. The first trust company of which record has been preserved is the Massachusetts Hospital Life Insurance Company, chartered in 1818. Funds placed on deposit with the company as a trust fund were aggregated and managed by it for a fee of one-half of one per cent of the capital. In fact, this company resembled most closely the investment trust of the fund type as recently developed and described above. It is still in operation.

The first company which received legislative powers to act in a fiduciary capacity was the Farmers' Fire Insurance and Loan Company, organized in New York in 1822, and later known as the Farmers' Loan and Trust Company. With the subsequent growth in the number of large individual fortunes, trust business grew rapidly, so that by the time of the Civil War about a score of such organizations were in existence. After the war, the large growth of the corporate form of organization created a great deal of so-called corporate trust business in connection with the issuance of securities, while the enormous increase in the number and size of large fortunes at the same time led to a vast increase in the so-called personal trust business. One after another, these companies also entered the banking business, at first without supervision, but gradually under restrictions similar to but often more liberal than those governing the operation of commercial banks with state charters.

In accord with the general tendency of banking toward the combination of many functions within one institution, trust departments have been opened by many national and state banks. The Federal Reserve Act of 1913 gave national banks the privilege of exercising trust powers, and this was further facilitated by the McFadden Act of 1927, giving these institutions perpetual charters for the first time. By 1929, national banks held nearly $4,000,000,000 in personal trust accounts, each trust account amounting to an average of $72,000.

No inclusive data on the total volume of trust funds have ever been compiled, although a survey in the State of Pennsylvania showed that trust companies and trust departments of other banks in that state held in excess of $4,000,000,000 in trust in 1929. For the country as a whole, the total probably exceeds $15,000,000,000, and is increasing rapidly from year to year. A survey made in 1928 of the business of 665 leading trust companies revealed a gain of 49 per cent in the number of trust appointments received in that year over the year before by these institutions.[1]

Types of Trust Business

The trust company plays a rôle in American investment banking in several ways. First, the banking department of such a company often possesses a larger proportion of time deposits than is usual, and thus acts in the same capacity as a stock savings bank. Secondly, the corporate trust business, wherein these companies act as trustees under corporate mortgages and as transfer agents and registrars for stock issues, facilitates the security transactions of other investment banking agencies. In the third place, trust companies, like many commercial banks, often maintain securities departments or security subsidiaries. Finally, they act as out-and-out investing

[1] *Proceedings*, Tenth Mid-winter Trust Conference of the Trust Company Division of the American Bankers' Association, New York, 1929.

institutions in the handling of personal trusts, and we turn to a discussion of this part of their business.

In the personal trust, the trust company supervises and manages the investments of individuals under fixed conditions. Personal trusts fall into two broad classes, testamentary and living. A testamentary trust, the more important type, involves the rôles of executor and administrator under wills, and appointment as guardian and conservator of the property of infants. Originally practically all trust business involved the care of property after the death of the creator of the trust. Lately, however, the trust company has to a growing extent been looked upon as a convenient agency for specialized management of an individual's affairs before his death as well.

The trust company is in a position to prove of inestimable value in testamentary trusts because it can give a special and personal service for which no other investing institution is qualified. A trust company supervises not only the investment of an estate, but also the expenditure of the income or principal after the death of the owner where this is desired. It claims several advantages over the individual executor or administrator for this function—it has perpetual life, specialized technical ability, and it can better avoid the family and other prejudices and squabbles in which individual trustees are often involved.

A special form of testamentary trust recently developed, which is rapidly growing in importance, is the life insurance trust. This trust consists of life insurance policies which will be paid into the trust and invested and disbursed according to the wishes of the testator upon the latter's death. By 1929, life insurance policies at the rate of about $1,000,000,000 yearly were being placed with trust companies, several of which formed special departments for this business. Another special development in this connection was a combination of savings accounts with life insurance which several trust companies developed in their banking departments.

The trust company has one peculiar feature as an investing institution—its fees are limited by law in most states. In New York State, for example, the fee consists of a percentage of the principal, combined with a percentage of the annual income. The fee on the principal, payable one-half when the trust becomes effective and the other half when it is terminated, amounts to 5 per cent on the first $2,000, 2½ per cent on the next $20,000, 1½ per cent on the next $28,000 and 2 per cent on all amounts over $50,000. The income fee, payable annually, consists of 5 per cent on the first $2,000 of income, 2½ per cent on the next $20,000 of income, 1½ per cent on the next $28,000 of income, and 2 per cent on all income over $50,000. Special agreements between the testator and the trustee may supersede these legal fees.

Living trusts are made by an individual for the benefit of himself or others during his lifetime. They come into effect immediately, thus differing from the testamentary trusts which become effective only after the death of the testator. The living trust is generally revocable.

The living trust, where it involves merely care of an individual's property during his lifetime, has been termed by trust men "guardian custodianship." This service includes investment advice, securities analysis and the development of a definite investment program. The trust companies recognize a trend in investment away from high-grade low-yielding bonds and toward diversified common stock commitments, and they seek to adapt their supervision to such conditions. In discussing this service, a leading trust officer has said:[1]

> The eight main advantages of guardian custodianship are: authoritative and continuous information, a scientific and carefully balanced program, automatic follow-up, due warning on unfavorable investments, relief from solicitation by unscrupulous security salesmen, automatic attention to subscription rights, conversion privileges, etc., composite judgment of a group of seasoned specialists and financiers, and control with relief from all administrative detail.

A cardinal principle of trust company operation in general is the segregation of assets, by which the trust funds are kept distinct from the funds of the trustee. In most states, and under the regulations of the Federal Reserve Board governing trust departments of national banks, corporate fiduciaries are

[1] A. F. Young, Vice President of the Guardian Trust Company of Cleveland, before the Tenth Mid-winter Trust Conference of the American Bankers Association of America, New York, 1928.

specifically forbidden to mingle trust funds either with their own funds or with those of other trusts.

Investing Activities

With regard to investment policy, trusts are either discretionary or legal. A discretionary trust is one in which the will or deed of trust specifies that the trustee shall have discretion as to the manner in which the property of the trust is to be invested. Where the grantor of the trust specifically designates the securities or property that are to stay in the trust, the trustee of course has no voice at all in the matter. This type is sometimes called a designated trust. If no statement as to the manner of investment is made, the trustee is restricted to the purchase of investments which are designated as legal trustee investments by the law of the state. Where the trustee does not adhere to the specific instructions of the trust instrument, or the legal trust investments where none are specified in the trust instrument, he is liable for all losses so incurred, and for each loss so incurred without regard to offsetting profits on other unauthorized investments.

Investments legal for trustees are generally specifically designated in the state laws, although in some states the surrogate's court rules on this matter.[1] The list of legal investments in the eastern states usually coincides roughly with the group of investments which are legal for savings bank funds. In New York State, trustees are allowed to invest in the same securities as savings banks, except that they are subject to less stringent limitations in purchasing real estate mortgages.

The trust company is the most elastic and adaptable of investing institutions. By restricting investment to "legals," which can be done either specifically or simply by making no mention of investments in the trust agreement, the same ultraconservative canons that govern savings bank investment may be secured for trust funds. On the other hand, the trust agreement may confine the trust to common stocks alone, and this has been done to an increasing degree in recent years. Finally,

[1] In Massachusetts, the trustee is given a wide range of discretion in his investing activities when no instructions are given in the trust deed, but his responsibility for loss in case he does not exercise the caution of a "prudent man" is correspondingly greater.

the establishment of a joint trust fund in which the individual merely holds fractional interests—the application of the investment trust idea in trust company operation—was tried as an innovation by the Farmers' Loan & Trust Company in New York in 1929, and bids fair to open up a new line of development in the investing activities of trust companies.

The trust company now not only gives general investment service, but offers to restrict its activity merely to the physical care and handling of the securities, leaving the owner full control over his investment policy. In this case, the trust company becomes merely the nominee, the securities being vested in its name to facilitate transfers, tax reports, etc. In cases where only safekeeping and collection of current income are desired, the trust company restricts its activities and makes a reduced fee accordingly.

The law endeavors to assure, as far as feasible, the independence of the trustee. With this in view, a trust department of a banking institution which also has a bond department may not purchase securities directly from the latter, although it may purchase from others securities in which the bond department is interested.

In its capacity as trustee, a delicate question arises with regard to the liability of the trust company in case of loss on the investments it handles. The trustee is under the control of the courts of equity, and a number of decisions have been handed down in these courts to create general standards governing such liability. The trustee is expected to exercise due diligence in the performance of his trust, and is held liable for losses due to carelessness or lack of prudence in the management of the trust investments, except where no discretion is allowed the trustee by the terms of the contract. The prime consideration should be safety of principal, although the trustee has also been held bound to secure the best return on the trust investments compatible with safety. The trustee, in other words, is expected to follow the same course of action as a prudent private investor.

An interesting example of the delicacy of this problem of trustee responsibility is the way in which the trust companies reacted to the discussion over the quality of German investments which arose in 1927. Many trust companies held German bonds in clients' accounts. Owing to the so-called transfer clause in the Dawes Plan and the terms of the Treaty of Versailles, which made reparations payments a first charge on Germany, the ability of the obligors on these bonds to make interest payments abroad was subject to some question. At least one trust company, in the desire to avoid liability later, as well as to protect clients' interests, felt called upon to dispose of such bonds when held in estates, and to give notice that such issues should be disposed of where held in custodianship accounts.

Investment Counsel

The investing institutions so far considered take over the management of the funds of the investor and keep custody of the securities purchased. In the case of the savings bank and investment trust, these funds are merged with those of numerous other investors. The trust company keeps the securities of each individual separately. But even the trust company, despite the highly individual and personal character of its service, manages and holds the property of the investor. There has recently been evident a new tendency toward the evolution of numerous firms of "investment counsel," who merely advise investors and give supervision to their holdings, while the investor retains custody of his securities and discretion as to whether or not he chooses to follow this professional advice.

The investment counsel thus gives part of the service which the trust company performs. For the large investor who wants expert advice, without giving up control over the investment of his funds to secure it, the investment counsel has proved adequate; and the cost of this service is generally small as compared with other forms of investing institution. Many financial statistical agencies have developed investment counsel activities as a by-product of their other functions.

It will be noted that in his advisory capacity investment counsel does virtually the same thing as the sales and service departments of the investment house. However, the investment counsel has the advantage of being impartial in his advice, if he is true to the best interests of his client, since he has nothing to sell. Several conservative brokerage houses which, since they profit by commissions only, are not interested in selling any one particular security, have become virtually investment counsel organizations. The adoption by the broker of the position of investment counsel, which he is often more adapted to occupy than the investment house, has been developed to some extent in Great Britain, as discussed in Chapter XXIII.

Summary

Three important types of investing institutions have been organized in this country to invest the money of numerous individual investors. The savings bank, collecting the funds of investors in the form of deposits, invests them according to rigid legal restrictions designed for great safety at the expense of the size of the return. It assures the investor conservation of and the right to withdraw his principal at all times. The investment trust, in its numerous forms, sells its securities to collect the funds of investors, and invests these funds subject only to any self-imposed regulations the management chooses to adopt. Safety of principal is subordinated for the most part to securing a larger return. Thirdly, the trust company gives a specialized type of service, caring for the property and funds of each individual separately, both in life and after death.

As the function of investment calls for more and more specialized skill, and as the volume of invested wealth increases, these investing institutions become of growing size and importance, and profoundly affect the whole field of investment banking. The investment house, which originates and distributes securities, finds that its selling is done increasingly to these investing institutions, rather than directly to private investors. Conversely, the individual investor finds that his investment requirements can be handled more effectively by one or another of these investing institutions, as they increase in number and in the extent of the services they perform.

From the point of view of the investment houses, these investing institutions constitute a wholesale market of great size for their issues, but of a special nature. In the first place, the investing is subject to certain regulations, which have been summarized in this chapter. Secondly, in the case of the investment trust especially, the investment houses have generally found that they can increase their power of distribution and expand their activity by controlling and managing such investment organizations. There has thus been an integration of functions, whereby investment houses and security affiliations of commercial banks have developed subsidiaries which function as unregulated investing institutions.

From the individual investor's standpoint, these investing institutions must be appraised by the same tests as he appraises securities—on the basis of safety of principal, safety and size of income, possibilities of appreciation, convenience and freedom from care, etc. In addition, the investor must determine how much he pays for the service and other benefits which the investing institution performs. If, for example, in a well-managed investment trust too large a part of the income is absorbed by the management, he may pay too dearly for this expert supervision of his investments. In this chapter the cost of operating the investing institution from the investor's standpoint has been discussed in each case.

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Chapter V

INSTITUTIONAL INVESTORS

Types of Institutional Investors

The preceding chapters have been occupied with a description of a number of institutions devoted to investment banking activities as their primary purpose. The security middleman—the investment house—forms the link between the capital market in general and the borrower or issuer of capital stock. A secondary market for these securities, which insures their marketability, has been developed with the aid of brokers, dealers and the stock exchanges. Specializing in the function of investing other people's money, and thereby forming a link between the investor and the capital market, is the investing institution—be it the savings bank, the investment trust, or the trust company.

In addition, a number of institutions devoted primarily to other than investment activities play an important rôle in the capital market as huge buyers of securities. Their other activities create the funds which they must invest, but when these aggregate funds take on very large proportions, the investment function, originally incidental, assumes great importance for these organizations.

The most important of these institutions, for which investing is an incidental rather than a primary function, is the insurance company. Formed for the purpose of spreading risks over the community, the insurance companies in the course of their business activity accumulate reserves which make them at the present time the most important single class of buyers of investment bonds. In New York State alone, life insurance companies have investments aggregating ten billions of dollars.

The commercial bank, long defined as an institution of discount, deposit and exchange, has been profoundly modified by recent economic and financial developments. Its investment functions have been largely expanded, even outside of the field of the savings department. Thus, in addition to being an investing institution, the commercial bank is becoming, as an incident to its commercial banking functions, an institutional investor as well.

The general run of business corporations is also becoming increasingly important as institutional investors. Many individual corporations act incidentally as investment trusts, holding hundreds of millions of dollars of securities of other companies, both within and without their own individual field of activity. Naturally, they cannot be ignored as factors in the capital market.

Universities, hospitals, churches, charitable organizations and foundations are all important buyers of securities. Their holdings in the aggregate amount to billions of dollars. Furthermore, the wealth in the hands of these institutions tends to increase from year to year, as the men who made great fortunes in the recent rapid expansion of the country's business structure pass on and follow the usual custom of leaving some part of their wealth to these eleemosynary institutions.

Insurance Companies

The business of insurance, one of the oldest in our economic order, steadily grows in importance with the increasing complexity and scope of economic activity. Insurance seeks to protect the individual by spreading the economic risks to which he is subject over large numbers of people. It is based on the fundamental rule that death and accidents happen to only a small number of people at one time, and therefore the individual may be protected from their adverse financial effects by means of small regular payments to a common fund. This is effected by collecting small sums from numerous people and using the fund thus gathered to pay losses to the individuals subject to the hazard against which it is sought to guard them.

The fund gathered to pay losses naturally assumes very large proportions as the insurance enterprise grows in size. It must be kept as a reserve from which losses are paid, thus making the insurance companies large holders of capital collected from the whole community, and kept for it. While the individuals taking out insurance protection do not always consider saving their major objective, the insurance company incidentally becomes the largest single type of saving and investing machine in the country.

There are two important types of insurance, differentiated by the nature of the hazard. Life insurance and such related types as old age and pension insurance seek to insure against a hazard certain to occur. The purpose of such insurance is to give economic protection to those who will be affected by the death of the individual insured, and the protective fund must be kept intact until this occurs. Hence, the reserves of life insurance companies become particularly large, for they must keep the funds of the insured over a long series of years until death closes the contract and makes payable the amount of the insurance. By including large numbers of people, the individual insurance company can avoid suffering very heavy losses at one time, and can keep payments from the reserve fund to a fairly regular rate. In fact, owing to the general growth of wealth, the improvement of medical science and the steady spread of the practice of taking out life insurance, the assets of these companies have increased by leaps and bounds during the past decade, and the reserve funds have grown rapidly despite the steady drain caused by payments on policies which have matured, either because of their limited term or because of the death of the insured.

Another group of insurance companies insures against a hazard which is by no means certain. The oldest form of insurance is marine insurance, which protects shipowners from casualties of the sea. Fire insurance is of a similar nature, as are accident, surety and other forms of insurance against events which may or may not happen. Casualty insurance of all kinds is generally written to cover one particular event, such as the voyage of a ship, or a short period of time, such as one- to five-year policies for fire insurance. The reserves of these companies naturally are much smaller as a result, and there is no steady accumulation of premiums over long periods of time against an eventual certain risk such as death. At the end of the period of insurance, all liability of the company ends, and any sums left over after all losses and expenses have been paid constitute its underwriting profit.

From the viewpoint of investment banking, the insurance companies are of special interest in two respects. In the first place, as large investors, the nature of their investment needs and the conditions under which they may and do purchase securities will be studied. Secondly, from the viewpoint of the individual, their efficiency and desirability as investment institutions will be discussed. Life insurance, as by far the most important type, will be considered first.

Life Insurance Operation

To furnish a background for understanding the problems facing life insurance companies as investors, a brief review of their operating methods is necessary.

All life insurance involves the payment of premiums, as individual contributions to an insurance fund are called, out of which benefits are paid to the beneficiaries named by those insured persons who die during the period for which they are insured. It is evident that insurance companies must determine these probable death losses in advance. This is done on the basis of the American experience table of mortality, which gives the probable number of deaths which would occur at each age in a group of 1,000 persons. The American experience table was prepared from empirical data many years ago, and is now considerably out of date, as the average expectation of life has risen materially in the meanwhile. Its continued use, therefore, means that premium rates now in force are more conservative than need be.

From the viewpoint of the insurance company, premiums received are its income, and death benefits paid constitute mortality costs. Income is further increased by earnings on the investment of premium funds, pending the time when they are distributed to beneficiaries as death losses. This investment income may be regarded as certain if the investments of the company are conservatively made. For this reason, life insurance premiums are reduced to allow for these expected earnings on the reserves. As a matter of fact, American companies, in computing their premiums, allow for earnings of

3 or 3½ per cent on their reserves, and reduce the amount due from policyholders accordingly. On the other hand, premiums are increased because of the expenses of operation of the insurance companies, resulting in a "loading," or additional charge.

The net earnings of the insurance company arise from three important sources. In the first place, because of the use of the obsolete American experience table and because of the rising standard of health in this country which accompanies the rising standard of living, death losses, or mortality expenses as they are called, are smaller than anticipated. In the second place, earnings on invested reserves generally amount to considerably more than the 3 or 3½ per cent expected. Thirdly, most companies, especially in view of the rapidly growing volume of insurance written, keep their expenses below the "loading" which is added to the premium. These net earnings in the case of mutual companies, which are owned by policyholders in much the same way as mutual savings banks are owned by depositors, are distributed to policyholders in the form of "dividends." They are obviously not true "dividends," however, but really represent an overcharge made of policyholders in their premiums, which is returned in this way. Where these "dividends" are paid, policies are said to be participating. Where the company is privately organized and these net earnings belong to the stockholders, the policies are called non-participating.

A final important feature of insurance company operation is the so-called level premium plan, which is in general use. If an individual takes out an ordinary life insurance policy calling for the payment of a fixed sum to his beneficiary at the time of his death, he will be required to make yearly payments as long as he lives. Actually, these payments should be on an ascending scale, for as he grows older there is greater likelihood of death, and therefore larger payments are required from all persons insured in that particular age group. But a scheme of rising annual premiums, while mathematically necessary, is in point of fact impractical, since the individual's ability to pay premiums tends to decline with age, after a peak of earning power is reached somewhere in middle life. Furthermore, the average individual's living expenses rise with age up to a certain point. Hence, the universal practice has been adopted by life insurance companies of fixing a uniform annual premium, involving over-payments in the earlier period to an extent large enough to cover under-payments in the later years of the policy. It is these over-payments which are largely responsible for the great size of insurance company reserves. Were it not for this level premium plan, insurance companies would tend to pay out yearly very nearly as much as they receive in premiums. Under this plan, however, a certain part of each premium payment in the earlier years of the policy's life goes into the reserve out of which later payments will be made in part. The size of this reserve is increased when the policy calls for payments for only a limited number of years, or when premium payments are further enlarged in endowment policies. The reserve accumulated against any policy constitutes its "cash surrender value," which the company is willing to return to the insured if he wishes to cancel the policy. It also constitutes the "loan value" of the policy, or the amount which it is willing to lend to the policyholder with the policy as collateral.

We now turn to a consideration of the investing operations of the insurance company.

Insurance Company Investments

Insurance companies, because of their close contact with the mass of the population, are subject to regulation by state law. Although state laws are far from uniform, nevertheless the requirements of the stricter states are generally complied with by life insurance companies. The reason for this is that the insurance company, while incorporated in one state, generally does business in many others as well. In order to be permitted to do business in, or be "admitted" to, others than their home state, insurance companies must conform to the laws of the strictest state in which they operate.

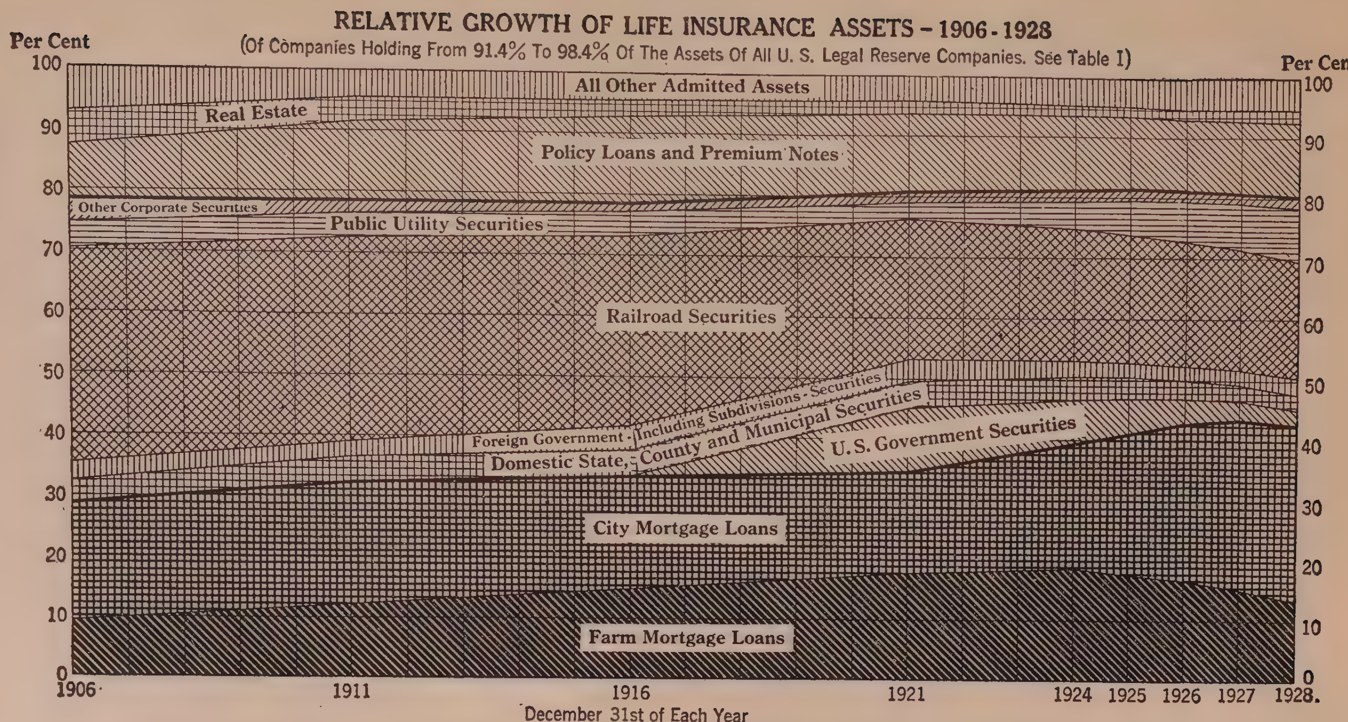
The insurance company usually has three funds from which its investments are made. First, there is the capital provided by the stockholders, except in the case of a mutual company which is run on the same principle as the mutual savings bank and is owned by the policyholders. In the second place, there is the surplus retained by the company from its past earnings. Finally, constituting by far the great bulk of the investment fund, there is the premium reserve paid in by policyholders, and held against future mortality losses.

The laws governing the investments of life insurance companies are generally more liberal than those governing the investments of savings banks, and the tendency has lately been to liberalize them further, in order to permit these companies to obtain moderately high yields on their investments as the volume of their assets has continued to grow from year to year. The annual increase in reserves has recently been in the neighborhood of a billion and a half dollars annually, a very large sum to be placed each year. The laws are not always designed to give maximum return consistent with safety, which should be the case in justice to policyholders. Frequently, extraneous considerations, such as the desire to induce companies to invest in favored localities or industries, govern. Thus, in Iowa and Nebraska, life insurance companies are restricted in the main to local securities, which means that the larger part of their funds actually go into farm mortgages in these agricultural states. The serious dangers of thus artificially delimiting the field of investment are readily apparent.

Laws governing life insurance company investments in the several states usually provide three separate sets of rules. The capital and surplus, usually up to the minimum required by law, are subject to specially stringent regulations. For foreign companies doing business within a state, the laws usually provide for special deposits of securities, which are subject to similar stringent requirements, that must be left with the superintendent of insurance. The remaining funds of the company, including the reserves and any part of the capital and surplus not covered by the above laws, are generally regulated by a third and less stringent series of regulations. These latter regulations determine, of course, the investment of the great bulk of insurance funds.

Under the laws of New York State, which govern the investment of more than half of all life insurance company funds in this country, the companies are allowed to purchase:

Fig. 6.



RELATIVE GROWTH OF LIFE INSURANCE ASSETS – 1906 - 1928
(Of Companies Holding From 91.4% To 98.4% Of The Assets Of All U. S. Legal Reserve Companies. See Table I)
Per Cent
Per Cent
All Other Admitted Assets
Real Estate
Policy Loans and Premium Notes
Other Corporate Securities
Public Utility Securities
Railroad Securities
Foreign Government - Including Subdivisions - Securities
Domestic State, - County and Municipal Securities
U. S. Government Securities
City Mortgage Loans
Farm Mortgage Loans
100
90
80
70
60
50
40
30
20
10
0
1906
1911
1916
1921
1924
1925
1926
1927
1928.
December 31st of Each Year

1. United States government and municipal bonds.
2. First mortgages on improved real estate up to 66 2/3 per cent of the value of the property.
3. Bonds of corporations which have earned at least 4 per cent on their capital stock for at least five years.
4. Secured bonds of solvent corporations, of which not more than one-third of the security is capital stock.
5. Preferred stocks of corporations which have earned at least 4 per cent on their capital stock for at least five years.

There was in this country in 1929 over $16,000,000,000 of life insurance company funds invested according to the legal requirements. This fund represented payments made by 62,000,000 individual policyholders, covering nearly $100,000,000,000 of life insurance policies. The distribution of this investment fund has been determined by the Association of Life Insurance Presidents, which makes an annual study of changes therein. A chart showing these changes over a period of years is shown in Fig. 6. Data made available by the association, covering more than 90 per cent of the assets of all life insurance companies held by 52 reporting companies, show the following distribution of assets on October 1, 1927:[1]

Security	*Amount*	*Per Cent of Total Assets*
Farm mortgages	$ 1,999,000,000	15.2
Other mortgages	3,717,000,000	28.2
All government bonds	1,115,000,000	8.5
Railroad bonds and stocks	2,574,000,000	19.5
Public utility bonds and stocks	1,019,000,000	7.7
Other bonds and stocks	208,000,000	1.6
All other admitted assets	2,548,000,000	19.3
	$13,180,000,000	100.0

The above figures show that 43.4 per cent of the assets of these companies were in the form of mortgages, while 37.3 per cent were in bonds and stocks, almost entirely the former.

[1] *Proceedings* of the Association of Life Insurance Presidents, New York, 1927, pp. 187-188.

They also show a preponderance of security investment in the railroad field, although there is a strong tendency now in favor of public utility issues, so that the percentage invested in the latter field is rising at the expense of railroad issues as the new money received by the companies as premiums flows into utility securities.

Life Insurance as an Investment

We have thus far considered the life insurance company as an investor. In reaching a definite appraisal of the full value of this type of institution as currently operated, it is also necessary to consider it from the point of view of the individual investor.

The purest type of life insurance is called term insurance, which runs for a limited period of years. In the case of a one-year term policy, no reserve need be set up out of the premium at the end of the year, so that the premium need be large enough to cover only the death losses paid on such policies during the year, plus expenses of operation. There is no investment element involved. But in actual practice, the bulk of insurance policies are not of the term variety. There are three important types of life insurance policies in addition to the term policies. These are:

1. *Straight or ordinary life insurance,* which gives protection for life and requires annual premiums to be paid as long as the policyholder lives. The excess premiums paid in the earlier years of the straight life insurance policy actually constitute an investment for the insured, on which he is allowed 3 or 3½ per cent and any excess earnings which the company may distribute in the form of "dividends." The investment character of these excess payments is indicated by the fact that the policyholder may withdraw them by canceling his insurance, getting back the "cash surrender value," or excess payments.

2. *Limited payment life insurance* gives protection for life, but limits the number of payments due to a specified number of years. Here the savings or investment feature is further developed. The annual payments are larger than the premiums

due in straight life insurance, the over-payments with interest thereon constituting a sum sufficient to pay the premiums for the balance of the expected life span of the individual. This form of insurance is in essence a combination of straight life insurance with an additional savings plan whereby an individual in his years of larger earnings accumulates a fund out of which to pay premiums in the later years of reduced earning power.

3. *Endowment insurance* emphasizes equally the insurance and savings or investment aims of the individual. The annual payments here are much larger, equaling, with 3 or 3½ per cent compound interest, at the end of a stated period of time the full face value named in the policy. The insurance equals this amount throughout the life of the policy, but if the insured survives to the end of the policy term he receives the accumulated sum intact. This type of contract is the equivalent of insurance protection for the period during which payments are made, plus a savings feature whereby the individual accumulates for his own benefit a sum of money paid to him in full at the end of the policy period, for which he makes additional payments to the insurance company.

It will be noted that these four forms of insurance policies differ primarily in the extent to which the investment element is added to the pure insurance factor. Considered purely in an investment aspect, life insurance naturally results in the accumulation of a considerably smaller sum than is possible through the placing of funds in savings banks or in conservative investment securities. The reason for this is that a part of the premium, or annual payment, goes to pay mortality losses of the company. The following table compares the accumulation which results from purchase of different types of insurance policies with that possible from investment of an equivalent sum at 4½ per cent compound interest. Most investors in securities would get a higher return under normal conditions. Of course, it must be remembered that the investor does not then get the insurance protection which creates a substantial estate for his beneficiaries before he has had the opportunity to accumulate a large fund for them out of savings.

Type of policy	Annual premium[a]	Accumulated reserve, equal to "cash surrender value"			Sum accumulated by 4½ per cent compound interest in 20 years
		End of 5 years	End of 10 years	End of 20 years	
Straight life	20.38	$ 45.76	$ 98.94	$ 230.50	$ 653.31
20-payment life.......	30.56	95.49	208.95	504.59	949.80
20-payment endowment	48.27	185.39	407.79	1,000.00	1,500.23

[a] Average, 8 large companies.

The majority of persons taking out life insurance do so because they want immediate protection against the hazard of death, and cannot wait for the long and slow process of accumulating a large principal sum through investment. From their point of view, the problem is not one of whether or not insurance is desirable in itself, for the answer to this question is necessarily in the affirmative. The real question is which of the several types of insurance is most desirable.

There are three factors to consider in answering this question. In the first place, the insurance policy has an advantage over most other forms of investment, in that it constitutes an automatic system for regular savings so that the investor has little opportunity for succumbing to temptation and failing to make his payments. From the point of view of the rate of return received, the insurance company does not measure up as favorably. Many, if not most, investors could make a larger return by taking out the cheapest kinds of insurance—preferably term or straight life policies—and investing directly any additional sums they have available.[1] To offset this larger return, however, there is the greater risk element connected with individual investment, except when carried on through a savings bank.

[1] The disadvantages arising from investing regulations compelling these companies to buy fixed income securities are discussed below in chap. xiii.

The weakest point in the position of insurance policies is that, as investments, they constitute a gamble on the chance of life, while as insurance they constitute protection against the chance of death. If an individual dies during the period of payment on a limited payment life insurance policy or on an endowment policy, his estate gets no more than if he had had a term or straight life policy. He has gambled on the chance of life and lost, in so far as he made the larger payments. Only if he lives does he get any benefit at all from these additional payments in the form of larger premiums. If his estate is small, this gamble on the chance of life is unfair to his dependents, whose share in the estate is thus reduced.

A recent study analyzed the rate of investment return received from the purchase of insurance with investment features by comparing cash surrender values of limited payment and endowment policies with straight life insurance policies, ignoring the small element of investment found in the latter. It was found that, at age 25, the limited payment and endowment policies gave an average return, as measured by the cash surrender value, of 2½ per cent on the extra payments over and above the straight life insurance premiums if the insured lived 5 years; 4 per cent if he lived 10 years, and 5 per cent if he lived 20 years. These are average figures based on data of 12 large companies. If insured at the age of 50, however, a return of 3¼ per cent was earned if he lived 5 years, and fully 8 per cent if he lived 20 years. The accumulation was, of course, entirely lost if the policyholder died before collecting from the company. Then his estate received merely the face amount of the policy, which would have been payable in any case. Thus, at the age of 50, the chance of the policyholder getting his accumulation, with income at the compound rate of 8 per cent, at the end of 20 years is found to be only 55¾ out of 100, based on his chances of living at least until the age of 70, as shown by the experience table.

As a conclusion of this study, the author says:[1] "A careful analysis of the situation indicates that in most instances it is desirable to keep life-insurance contracts separate and distinct

[1] Nerlove, S. H., "The Investment Element in Life Insurance Contracts," *Journal of Business of the University of Chicago*, vol. i, pp. 273-293, July, 1928.

from investment contracts—to buy life-insurance services from a life-insurance carrier and investment services from an investment institution."

The combination of insurance and investment activities through a bank and trust company has been tried in recent years, in order to avoid the disadvantages mentioned above attaching the insurance company as an investing medium. Several banks have worked out schemes for acquiring insurance for savings depositors, paying premiums out of the interest earned on savings accounts. The Harris Trust & Savings Bank of Chicago installed such a combined savings-insurance system in 1921, and has developed it considerably.

Another combination of life insurance and investment activity is present in the insurance trust, especially where the individual who creates the trust places securities as well as life insurance policies in it. The earnings from the securities can then be used to pay premiums on the insurance policies; or some other arrangement can be perfected to assure that the investment side of the transaction, both before and after death, shall be handled by the trust company, while the insurance company merely furnishes the term or straight life insurance contract.

Fire and Casualty Insurance Companies

The other kinds of insurance companies are far less important as institutional investors. This is the case chiefly because of their method of operation, which involves insurance for short periods and thus does not permit the building up of large reserves. Furthermore, these companies, since they do not affect the general public so largely, are subject to far less stringent regulation than is the case with the life insurance companies, so that most of them buy heavily of common stocks and often make a large speculative profit on their security holdings.

As a matter of fact, most fire and casualty companies do not charge enough in premiums to cover their loss payments. The difference, as well as their profits, is made up from profits made by investing these premium payments as rapidly as received, and before losses are paid out. In fact, taken together, fire insurance companies show underwriting losses almost yearly, but investment and speculative profits have made many of these companies highly prosperous.

A recent study of 63 leading American fire insurance companies shows that they had investments aggregating nearly $1,250,000 in 1927, of which nearly one-half was in stock. Several companies had the larger portion of their funds invested in industrial and utility common stocks, while others, more conservatively inclined, continue to rely chiefly upon bonds as investment media. A total of 25 leading casualty companies considered had more than $550,000,000 of investments, and showed a steady tendency to invest more heavily in stocks, in which they had about one-fourth of their funds.

The Revolution in Commercial Banking

The growing financial strength of the individual American business corporation, making it less dependent upon the bank than ever before, has had a profound effect upon the activities of the commercial banks. Many a corporation which formerly turned to the commercial bank for credit facilities now has a surplus of liquid capital which transforms it into its own banker. Instead of seeking credit from the banks, many of our corporations are lending money on call through the banks. Even in the case of corporations which do need additional capital, the great development of the securities markets often makes it more desirable to finance through them by the sale of stocks and bonds, rather than depend upon the short-term loan and close supervision exercised by the commercial bank.

The commercial bank, finding it impossible to utilize its resources in wonted channels, has had to branch out into other fields, notably investment banking in its several phases, such as underwriting, and lending for security speculation and trust activities. It has diverted an increasing volume of credit into loans to brokers and bond houses, as well as into real estate loans. It has also purchased heavily of securities over and above purchases made with savings deposits, thus becoming an important institutional investor.

The total volume of bank credit outstanding in the United States on June 30, 1928, was estimated at $56,000,000,000 by the governor of the Federal Reserve Board. This total was distributed in the following manner:

U. S. government bonds	$ 6,000,000,000
Other stocks and bonds	12,000,000,000
Loans on securities (of which amount $3,000,000,000 is represented by so-called brokers' loans)	13,000,000,000
Loans on real estate security	5,000,000,000
Loans to customers (of which amount it is estimated that approximately $5,000,000,000 is eligible paper held by member banks)	20,000,000,000
Total loans and investments	$56,000,000,000

The true nature of the revolution that has taken place in the position of the commercial bank may be understood only by differentiating investments and investment loans made with time deposits from those made with demand deposits. In so far as the commercial bank receives time deposits and invests them as does the savings bank, it is merely acting as an investing institution, in the manner described in the preceding chapter. It is only when it invests its resources over and above its savings deposits in securities that the commercial bank also acts as an institutional investor.

The investments of commercial banks and banking departments of trust companies were distributed as follows in June, 1926, according to the report of the Comptroller of the Currency:

Type of bond	National banks	State banks	Trust companies
U. S. government	$2,469,268,000	$ 564,182,000	$ 344,681,000
Municipal	647,801,000	226,093,000	126,233,000
Railroad	631,387,000	60,151,000	277,521,000
Public utility	545,036,000	87,292,000	211,776,000
Industrial, etc.	772,789,000		
Foreign government	225,871,000		
Other foreign claims,	146,548,000	2,242,682,000	1,846,569,000
warrants, judgments, etc.	403,553,000		
Total investments	$5,842,253,000	$3,180,400,000	$2,806,780,000

The Corporation as Investor

There is one peculiarity of American corporate accounting practice which has had a remarkable effect upon the investment process in this country. As a result of the kaleidoscopic changes through which most of our industries have passed, and especially on account of the almost indefinite field for rapid expansion they have faced, the corporate surplus is ubiquitous in American finance today. Whereas in Great Britain and on the Continent the general rule is for the corporation to pay out to its stockholders the great bulk of reported earnings, after putting aside certain relatively small statutory and other reserves, the practice here is as a rule to pay to stockholders in dividends only a fraction of the annual corporate income. The balance is ploughed back into the property.

The corporate surplus was a natural outgrowth of the special conditions under which American industry grew up. This is revealed by a study of our early corporations. The first railroads, for instance, originally followed the policy of paying out in dividends all their earnings. The annual income, in fact, was considered a "dividend reserve," and anything not paid out was immediately labeled in this way, to be paid out as soon as practicable. Any other course, it was thought, was an imposition on the stockholders.

The rapid progress of industrial change soon showed that such accounting practice was not suitable to American conditions. This was early discovered by the big railroads. Rapid railroad building brought competition, and competition brought about the failure of the companies which did not have extra resources to carry them through lean years. Also, with the rapid change in technique, facilities often became obsolete long before the termination of their estimated lease of life. Corporations without a corporate surplus were then compelled to reorganize, in order to raise the needed capital for the modernization of their property. The philosophy of a corporate surplus was one of the chief factors that made the Morgan reorganizations successful. Finally, with the growth of the country, many profitable opportunities for expansion arose, and boards of directors frequently preferred to use current earnings to take advantage of these opportunities, instead of turning their income over to stockholders and issuing additional securities to finance new ventures of doubtful immediate profitability.

As time went on, the accumulation of a corporate surplus of large size, and continued payments of only a fraction of earnings as dividends, became one of the habitual practices of American business life. The practice followed in the railroad field is shown in the following table, giving the percentage of earnings paid out in dividends by such companies over a period of years:

Year	Net income	All dividends paid	Per cent of net income paid as dividends
1890	$106,270,095	$ 87,671,613	81.9
1900	252,760,482	139,597,972	55.2
1910	583,191,124	405,771,416	69.6
1920	481,950,969	331,102,938	68.9
1925	771,053,077	409,645,051	53.1
1926	883,421,795	473,682,830	53.6
1927	741,923,916	567,280,717	76.5

Among public utilities, a number of companies have changed their practices in recent years. They have retained most of their earnings, but many of them pay out to stockholders liberal amounts of stock as dividends, thus giving them the immediate benefit of the earning power in the form of marketable securities. Fear that regulatory authorities would not permit them to earn a full rate of return upon reinvested capital unless evidenced in securities is one of the factors which led to this change, for the railroads have not been able to enjoy the full benefit of their large surpluses, and the utilities seek to avoid the same experience.

The size of the surplus accumulated by several leading industrial corporations is indicated in the following table:

Company	Par or stated value of common stocks	Surplus, December 31, 1927
U. S. Steel Corporation	$711,623,500	$633,044,913
American Can Co.	61,849,950	43,851,369
Standard Oil Co. of N. J.	607,930,475	400,142,932
American Car & Foundry Co.	30,000,000	40,138,673
Du Pont de Nemours Co.	133,082,900	124,472,266

The stockholder benefits from these surpluses in the course of time through the payment of stock dividends, or through the splitting up of stock after the rising earnings per share resulting from the steady ploughing back of profits cause the price of the stock to rise to high levels.

The habit of building up a large surplus has resulted in the transformation of our leading corporations into virtual investment organizations. A spectacular example, one of many which might be cited, is the du Pont Corporation. Founded in 1799 as a munitions manufacturing plant, this company in the latter years of the nineteenth century built up a large business as a manufacturer of powder and explosives, used for the most part in mining and building operations. The company's activities then were extended into the chemical field. During the war, it took a foremost place in the manufacture both of munitions and chemicals, the main source of supply of the latter having been cut off through the closing down of trade with Germany.

The huge profits obtained during the war period were not paid out to stockholders to any important extent. Although the vast liquid capital which the company accumulated certainly could not be used in the munitions business, and the chemical business was expanding at a rate which held out prospects for profitable employment of only a small proportion of it, no steps were taken to distribute it. Instead, the company turned to an entirely different industry, automobile manufacturing, where the difficulties of one leading promoter permitted it to acquire a controlling stock interest in the General Motors Corporation. Thus the company became a leading powder and explosive manufacturer, a manufacturer of chemicals with stock interests in numerous other concerns in the same field, and finally the holding company for the largest automobile manufacturing concern in the world. The relationship between the market valuation of the General Motors investment of the company and its own total valuation, as measured by security prices on April 1, 1929, was as follows:

Market value of du Pont capitalization—	$1,751,284,150
Market value of shares of General Motors held as investment—	823,450,650
Market valuation of balance of du Pont assets—	927,833,500

The corporation as such has, as a matter of fact, become the greatest single engine for saving in modern economic organization. The device of the corporate surplus, designed at first to strengthen the corporation's position in its own industry, has in numerous cases continued to accumulate capital in individual enterprises after the opportunities in the industry become too limited to permit its use. As a result, corporations have accumulated large amounts of capital which have been kept in liquid, mobilized form awaiting use in one channel or another. In times of high rates on call loans to brokers, these corporations lend billions of dollars in this way.

This brings us to the second phase of development of the corporate surplus, where it assumes merely the form of excess liquid capital awaiting profitable investment. A number of corporations, following the business practice quite suitable to conditions of an earlier day, have accumulated huge amounts of liquid capital for which they find no apparent use, and which will eventually modify to a large extent the prejudice of boards of directors here to the custom of paying out all earnings as dividends when no use can be found for further accretions to surplus. The net working capital on January 1, 1928, of leading American industrial enterprises shows the extent to which they possess such liquid capital resources:

Company	*Net Working Capital*
General Motors Corporation	$272,923,976
U. S. Steel Corporation	424,337,475
American Locomotive Co.	48,393,736
Allied Chemical Co.	133,079,843
Atchison, Topeka & Santa Fe	57,523,074

Pending the finding of favorable use for these funds, corporations generally seek some profitable investment for them. They can place their money on call or in short-term securities, or, in certain cases, they can act as investment trusts, buying and selling securities for profit as well as current income. "Corporation buying" has become a real factor in the investment and speculative markets. In times of business expansion, or when new industrial methods make additional plant construction necessary, these securities can be liquidated to provide the necessary funds. The ordinary business corporation then acts largely as does the fire insurance company, which invests its liquid funds pending the time when they are to be paid out as losses.

The growth of corporate surpluses, especially in liquid form, is merely one instance of the fundamental change in the position of this country from a debtor to a creditor nation. This is reflected in the individual corporation by the fact that, instead of having to borrow additional capital to expand its activities, it has a surplus for which no definite use is in sight. The same process is here repeated as occurs in the country as a whole, where a surplus of liquid capital is available now for investment abroad, whereas formerly resort had to be made to foreign capital markets in order to raise the funds needed for the development of home industry by American corporations.

Eleemosynary Institutions as Investors

A large and growing group of eleemosynary institutions constitutes an important factor in the capital market. The largest of these, the Rockefeller Foundation, has assets in the neighborhood of $250,000,000, kept mostly in securities, the income from which is spent for benevolent purposes. These investments are made, subject to the deed of trust establishing the Foundation, by a board of trustees.

The most important and most rapidly growing group of eleemosynary institutional investors is made up of the colleges and universities. Most American institutions of higher learning, outside of the state and municipal institutions, do not receive enough in fees or subsidies to cover the cost of the educational work offered. The balance is made up from income earned on endowments presented to the institutions by benevolent individuals. These endowments sometimes take the form of land or securities which the institution is expected to retain. To a growing extent, however, they are free endowments which the institution is at liberty to invest or reinvest at the discretion of its board of trustees. Thus, Harvard University reported on June 30, 1928, that it had endowment funds totaling $86,702,876. However, this amount was substantially below the market value of the securities held, as may be seen from the comparison between book and market values of the following common stock holdings of the university:

Number of shares	Stock	Price per share on books	Market price per share in 1929
1,000	American Gas & Electric	$124	$149
5,379	American Tel. & Tel.	88	200
2,000	Columbia Gas & Electric	113	148
3,369	Electric Bond & Share	21	211
1,963	International Tel. & Tel.	77	215
2,167	Western Union Telegraph	103	195
2,514	Amoskeag Manufacturing	23	195
500	Case Threshing Machine	300	480
400	Deere & Co., Inc.	356	600
1,250	Drug, Inc.	[a]	121
1,000	Eastman Kodak	110	184
12,836	General Electric	[a]	235
1,000	International Harvester	256	314
8,053	United Fruit	38	142
2,800	U. S. Steel	71	190

[a] Nominally valued on books at $1 for entire lot.

Reported general endowment funds of the ten wealthiest universities amounted to nearly $500,000,000 in 1929.

The investment policy typical of a large university may further be gauged from the way in which the general fund of Harvard, amounting to some $61,000,000 in 1928, was invested. Railroad securities constituted about 22 per cent of the total, and public utility issues 34 per cent. The bulk of these consisted of bonds.

With the increasing number of rich men who follow the practice of giving or bequeathing large sums to eleemosynary institutions, the other organizations in this group are becoming increasingly important buyers of mortgages, bonds and stocks. Hospitals and churches constitute the most important organizations outside of those mentioned. In addition, an increasing number of cities have established "community trusts," under the supervision of trust companies, which receive general bequests that are distributed among all the benevolent enterprises in the community.

The investing activities of these educational and benevolent institutions are not subject to any legal regulation. They are subject, of course, to the wishes of the donors of the property, where they are specified in the deed of gift. In other instances, conservative and rigid regulations have been self-imposed by the board of trustees of the institution to govern their own activities. While many of these institutions keep within the limits of securities legal for savings bank investment in the interest of safety, others show a greater disposition to sacrifice unnecessary marketability and to take advantage of appreciation policies inherent in common stock investment. Furthermore, in the operation of their investment accounts, many of these institutions have the benefit of the advice of investment bankers who are on the board of trustees, while in other cases financial statisticians may be employed to search out investment opportunities.

Summary

There is a large and important group of institutions, not formed for the primary purpose of investing funds of individuals, which nevertheless gather in the course of their business large sums which must be kept profitably employed. These institutions play an important rôle in the capital market.

The leader among these institutional investors is the insurance company. In the case of life insurance companies, the business of insurance is complicated by a large investment element, because of the adoption of the level premium plan of payments and the addition of endowment features to policies. These methods of operation have made it necessary for the life companies to accumulate huge reserves, the investment of which is regulated by state law. From the investor's standpoint, on the other hand, the combination of insurance and investment activities which results does not always prove ideal.

Other insurance companies and commercial banks also accumulate substantial funds which are kept invested in securities, under regulations imposed by state laws. Numerous business corporations have large sums available for general investment, to a great extent a result of the almost universal practice of American corporations of paying out only a portion of their earnings as dividends, regardless of the immediate expansion needs of the enterprise.

Finally, eleemosynary institutions are gaining the control of increasing amounts of money which are being largely invested by them in securities. Colleges and universities are most important in this respect; but churches, hospitals and other religious, benevolent and educational foundations are also becoming important institutional buyers of securities, and their investing activities play a conspicuous part in the capital market.

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Chapter VI

MORTGAGE BANKING

Purpose and Types

Investment institutional development has produced a special type of organization known as the mortgage bank, which is both a buying and selling undertaking.[1] It is based upon the concept of substitution of joint for individual credit, and in some cases is equivalent to joint guarantee of individual credit; it is worked out in such a way as to use this principle for the protection of the investor. The special peculiarity of mortgage banking is, in fact, found in an attempt to strengthen credit, and make it broadly acceptable, by averaging or combining risks.

The term "mortgage banking" also includes the converse service rendered by a group of institutions whose function it is to bring about the same object by distributing risks rather than by combining them through reducing the risk carried by any one owner by giving him only a share or fraction of a large mortgage.

As the name implies, mortgage banking is a form of investment banking whose purpose is to finance the purchase and development of real properties through the sale of mortgages. Under it are included two major divisions: one usually called rural credit or farm finance, the other real estate financing or city mortgage banking. Both have a common purpose, but their methods are widely different. Of the two branches of mortgage banking, the rural phase is by far the older, and has been more perfectly worked out than has city mortgage bank-

[1] Mortgage banking is not a term that applies narrowly to the making of mortgages. In the first stage of mortgage banking, the basic instrument was a first mortgage secured on land. As the system is working out today, mortgage banking is considerably broader than that, and the underlying conception applies to all classes of collateral bonds of which the basic security consists of instruments which are secured by a lien on land or buildings.

ing. Rural mortgage banking also has the advantage of resting upon definite legislation in most countries.[1] Many nations have adopted what is called rural credit legislation—legislation, that is to say, which aims at the financing of farm purchase and the development of land by the mortgage method.

There are only a few countries in which the development of mortgage banking in cities has been subjected to legislative control, or has been given any legislative recognition or aid. This discrimination is due to the fact that in most countries the so-called agricultural problem—that of keeping the farmer on the land and of providing him with reasonably cheap working capital—has been regarded as primarily important from various standpoints, so that much more attention has been given to it than to the parallel problem of city real estate financing. Some countries and states have special laws designed to authorize and regulate city mortgage banking for city development, but this special form of mortgage banking has been largely left to develop itself.

Methods of Rural Credit Extension

We may, to advantage, begin our analysis with a study of methods of rural credit extension. These are best seen in the United States under the federal farm loan system. The Federal Farm Loan Act of 1916, upon which the system rests, authorizes the creation of local lending units called farm loan associations. These are made up of the owners of land in a community who want to borrow. They come together and form a local enterprise which has a stock capital of a stated

[1] The borrower has a primary object to serve. Successful mortgage banking of any kind is in fact successful not merely when it helps the lender, but when it helps the borrower as well. So we may say that the social object of mortgage banking from the standpoint of the borrower (the farmer) is to give him better access to the capital market. In most countries he has only a poor access, and thus mortgage banking is a system specially designed to meet his needs. In this country he could formerly get his funds from the local bank or from the individual mortgage lenders who were engaged in the business and getting high commissions and high rates of interest. These conditions have been improved by developing a special system framed from the borrower's standpoint, as illustrated in our farm loan system—that of giving the borrower access to capital steadily, consistently and at a lower rate of interest. Rates have been reduced 1 to 1½ per cent during the past ten years, in relation to other interest rates, as a result.

amount, and they then receive applications from the various members composing the association for the amount of money which each deems desirable for use in his farming enterprise. Such applications are passed upon by the group comprised in the farm loan association. Knowing one another's land and methods of cultivation, they are considered able to appraise, more or less accurately, the character of the underlying credit, and to decide about how much each member of the group ought to be "good" for.

Having made up their minds as to the total mortgage loan which they are willing to recommend in each case, an application is made by them to a farm land bank, of which there are twelve, situated in districts which together comprise the whole continental United States and which roughly correspond to the Federal Reserve districts into which the country is divided. The farm land bank has its own system of appraisals and valuation; and should it decide that the loan application is sound, it immediately communicates its approval to the local loan association, where the mortgages are duly made out and transmitted to the farm land bank.

Under the terms of the law, each borrower is obliged to subscribe 5 per cent of the amount of the proposed loan to the stock of the local association. Inasmuch as the mortgages, when transferred to the farm land bank, are endorsed or guaranteed by the local association, this 5 per cent constitutes a local guarantee fund protecting the farm land bank against losses due to default on mortgages. The provision is based upon the theory that, if the lending process is carefully and skillfully carried out, losses ought not to average more than 5 per cent at the worst. It will be noted that the mortgages thus made and eventually owned by the farm land bank of the district have been safeguarded by at least two appraisals of the land (that of the local association and of the farm land bank), and by the establishment of a guaranty fund equal to 5 per cent of the face of the loan. The farmer who borrows on mortgage thus receives in cash only 95 per cent of the face of his mortgage; but when he comes to pay off his loan, he can dispose of his stock in the association, and if it has been wisely managed he will receive the full face of what he put in, or more.

Furthermore, he will be paid 6 per cent dividends on this stock if earnings are available.

Federal Farm Loan Bonds

The farm land bank evidently can buy mortgages only to the extent to which it has a paid-up cash capital of its own, unless it resorts to some method of enlarging its cash funds. This it does by taking the mortgages as they come in, arranging them in series, placing them in trust under the control of a designated officer, and then issuing, upon them as security, an equal volume of farm land bonds. These farm land bonds then evidently represent the entire pool of mortgages. The holder of one thus becomes part owner of a general fund of mortgages representing a claim upon the land of a specified district. His safety lies in the fact that, although some or even many of the mortgages may have been unwisely made or may be vitiated by flaws in title, or may be otherwise defective, the great bulk of the mortgages taken will not be thus vitiated, but will be "good."

Under the law of averages, the holder of a farm land bond is theoretically in a much safer position than the holder of one of the mortgages. He is protected, of course, not only by the appraisals and by the withholding of 5 per cent of the money loaned, already referred to, but he is further protected by the fact that his security is specifically segregated, apart from the other assets of the farm land bank, while he has also the original capital of the bank as a possible source from which losses may be paid.

In order to grant further assurance, Congress has made the liabilities of any farm land bank the liabilities, jointly, of all the others. A farm land bond is thus, in one sense, a fractional claim upon the land of the United States. Under proper conditions, it is therefore about as sound and secure an obligation as the entire agricultural industry of the United States can put out. The essence of the transaction has been to average risks and divide them, at the same time providing an insurance fund to cover possible losses. This is mortgage banking; and the effect of it is to eliminate the older practice of direct financing of farm operations through loans made by individuals to individuals, the substitute being found in the coöperative action and joint liability of the borrowers, with division and distribution of risks among a great number of investors.

How Bonds Are Marketed

The mere fact that the farm land bank has prepared and has ready for issue a series of good bonds, does not place these bonds in the hands of investors. It is necessary to find a good means of distribution. This might be accomplished by direct sale to investors in small lots, or by actual distribution through the efforts of bond salesmen or otherwise, or by advertising the availability of the bonds and leaving it to the investors to come in voluntarily and take them up.

As a matter of fact, the farm land banks have found it expedient and economical to approach the investor through the medium of an already organized bond house possessed of good distributing facilities and qualified to reach the sources of investment funds. It has been able to get the services of such bond houses on a very moderate cost basis, so that it has not thought it wise to establish its own marketing machinery, although there is no fundamental reason why it should not do so.

The situation which has thus been described may be compared to advantage with a method formerly widely employed in Germany, where agricultural credit has long had a very elaborate and systematic development. In accordance with this plan, it was the practice in Germany to form groups of farmers who jointly undertook to guarantee one another's credit. Applications from members of the group, when made to the office jointly representing the entire body of farmers, would be considered with care; and if granted, the applicant would be allowed to present a mortgage upon his land, receiving in return the joint bond of the organization for an equivalent amount, less expenses. These bonds usually bore a rate of interest believed to correspond roughly with the rate prevailing in the market for similar sound securities, and they would then be handed to the farmer-borrower to dispose of as he thought fit. This placed upon him the necessity of marketing the bonds; and the result of the borrowing transaction was merely to give him, instead of his own obligation, another obligation representing the credit of the group to which he belonged. It was as if all members of the group had united to endorse the paper of any one of them who might be accepted as a borrower. This obviously gave to the farmer a much stronger and more widely acceptable credit instrument than his own individual obligation could ever be. He could at times sell it to some neighboring organization, such as a savings bank, while at other times he was obliged to have it sold in a distant market.

Eventually, German farmers developed a plan of creating mortgage banks whose duty it was to deal in these bonds, and thus a system very similar to our plan of marketing was evolved. In most countries, the task of marketing is regarded as too technical for the local borrower to undertake. Obviously, he cannot market such paper with success, unless there is a substantial demand for it in his immediate neighborhood. Such a plan works well, therefore, only where the savings of a community are about equal to the new capital which that community wants to use in development. Mortgage banking then comes in as a means of coöperatively guaranteeing the paper of borrowers, which is then taken up and carried by those who are doing the saving of the community. Where, as in the United States, saving sections and capital-using sections are not identical—the West, for example, being a habitual consumer of capital, while the eastern states are habitual exporters of it—mortgage banking involves both the element of coöperative guarantee and the element of disposal or distribution of securities in a distant market. It thus performs the function of bringing together two widely separated geographic areas.

Joint Stock Land Banks

Attention has thus far been given to the federal farm loan system of the United States, but it is not the only means by which rural mortgage banking is carried on in this country. As a matter of fact, the Federal Farm Loan Act provides for the creation of individual land banks, to be organized wherever there is a need for them, through subscription of private capital.

These banks differ from the farm land banks chiefly in the elimination of the coöperative principle. Their capital comes from individual subscriptions, and they loan not to the associations which in the farm loan system represent the local unit through which advances are made, but directly to individual borrowers. Altogether, the joint stock land bank, while undertaking to perform the same kind of service that had been undertaken by the farm land banks, does it in a much simpler and less systematic way.

Under the Farm Loan Act 57 such banks were organized; and of these there have remained 54, the other three having been placed in the hands of receivers. These banks have done a regular mortgage loan business, lending to customers who presumably have good landed security to offer. They have then placed the mortgages growing out of these transactions in trust, and on them have issued bonds which have been sold to investors who have thus been protected by the segregated mortgages underlying them, as well as by a general lien upon the assets of issuing banks, effective in the event that the mortgages themselves should not prove at any time to be a wholly satisfactory protection. It is worth while to note the steady growth of the outstanding volume of such bonds in the American market, both when issued by the federal land banks and when issued by the joint stock land banks. A tabulation of these issues is as follows:

Year	Total federal land bank bonds outstanding	Joint stock land bank bonds outstanding
1921	$ 434,535,000	$ 81,510,000
1925	982,192,000	516,144,000
1926	1,059,217,000	605,262,000
1927	1,139,617,000	582,049,000
1928	1,161,248,120	591,503,700

The bonds which have thus been offered to the public were from the beginning greatly favored by exemption from taxation. As a result, they have been quoted at relatively high figures and have been sold at low rates of interest which would not otherwise have been possible. The following table furnishes the quotations of some representative farm land bonds, and by way of comparison there are also furnished figures showing contemporary quotations of U. S. government bonds (as of June 1, 1929):

Issue	Price	Yield
Federal Farm Land Banks 5's	$ 97	5.05
Lincoln Joint Stock Land Bank of Lincoln, Neb.	94	5.15
U. S. Treasury 4's of 1944-54	103	3.72

Urban Real Estate Finance

In a number of cities there has developed a system of mortgage banking parallel to and in some respects like the rural credit systems which have just been reviewed.

For many years past, savings banks have been in the habit of lending a large part of their funds upon the security of first mortgages on real estate. At times they have sold these mortgages to their clients, and thus the latter, when they desired to withdraw savings funds, have been paid by simply giving them a good mortgage out of the portfolio of the savings bank. Later, so-called mortgage companies or title and trust companies were developed, with the function of lending on mortgages and then reselling them to investors. They were, in their beginnings, mortgage loan brokers. It was a comparatively easy step to undertake various insurance functions in connection with them. In some cities such companies took up the task of insuring the titles to property, and from this they then passed to an insurance of the principal and interest of the mortgage. Such insurance was possible by reason of the fact that the companies had made very careful investigations of titles, security, and the like, and were the holders of large masses of records, besides being equipped with substantial capital. The number of mortgages which they had to take back, or redeem, as a result of some flaw which rendered the debts uncollectible, was small where the business had been carefully done, and thus their losses were often nominal. At all events, the losses were never so great but that a mortgage charge, spread out over the general body of mortgages and added to the interest paid by the borrower, would cover them. Thus a kind of mortgage banking could be practiced, even without the use of the principle of trusteeing the mortgages and issuing bonds against them. This latter principle, however, had been found very useful and profitable in furnishing rural credit, and its application to city real estate financing was only a question of adaptation to the different conditions that presented themselves in city land finance.

By pooling the mortgages which had been taken by title and trust companies or by mortgage bankers, placing them in the hands of a trust company or other trustee for safeguarding, and issuing bonds or certificates against them, city mortgage bankers finally took the step which has usually been regarded as characteristic of mortgage banking in the full sense —the establishment of a fund or pool of mortgages against which securities were issued. In this way, they were able to proceed with mortgage lending operations up to the time when a substantial part of their capital was engaged in it, and could then get back their capital by placing the mortgages already taken in trust, and selling claims against them.

The mortgage bankers profited to the extent of the difference between the interest on the mortgages and the interest on the bonds or certificates which they sold against them, and they of course earned an income from fees for title examination, brokerage, and other services. By turning over their capital as frequently as possible, they were able to charge these fees upon a correspondingly increased body of loans. On the other hand, the buyer of the bonds or certificates was better off than the buyer of individual mortgages so far as security was concerned, because he was now in possession of a direct claim upon the issuing company which at the same time was protected by a great number of mortgages, and so was free of any except that general risk which might be regarded as inhering in all such investments.

Of course, he was not able to expect as high a rate of interest as he would have received on the individual mortgage. Because of the greater safety furnished by guaranteed mortgages and by the pooling of risks, he was freed of worry about the flaws that might exist in any particular loan, and could base his confidence entirely upon general conditions as they might exist in any given community. Thus the bonds and certificates of the kinds created in this way have come to be regarded as an exceptionally safe type of real estate investment, with a correspondingly moderate interest rate.

Financing Office Buildings and Apartment Houses

The mortgage banking idea as applied to city real estate has of recent years been given a new turn in connection with the financing of office and apartment buildings and large structures in general. Modern American city development has come to demand the erection of very large and costly structures which, in ordinary circumstances, could not be built by the efforts of any one individual, or even by a small group of individuals. Accordingly, it has been necessary to find a means by which the ownership in such buildings could be subdivided and capital for their construction obtained from a large body of investors.

In order to carry out this plan, it has become customary to place a mortgage upon a given building, either before, during or immediately after construction, and with its proceeds pay off the expenses involved in building. The mortgage is made out in favor of a trustee, usually a trust company, which acts as a fiduciary on behalf of the bondholder. An equal amount of bonds is issued and offered to investors. Thus, when the bonds have been sold, the investors become part owners, in proportion to the number of bonds taken, of the underlying mortgage itself. The trust company or trustee thus assumes the duty of paying the coupons on the bonds out of interest which it has collected from the owners of the building. It retires the bonds as they fall due under an amortization scheme, which has usually been put into effect to protect them; and, should the building owners default, it will foreclose the mortgage and take possession of the building on behalf of the bondholders by bidding it in at special sale on their behalf. The assumption in the whole undertaking, of course, is that this latter step will not be necessary, that the investment is a sound one, and that the issue of bonds has merely enabled participation in a security that would otherwise have been outside the reach of the ordinary investor.

The nature of large-scale urban real estate financing is indicated by the following classification of such issues publicly made for 1927:

Apartments	$ 403,752,400
Office Buildings	271,725,750
Hotels	102,897,000
Theaters	100,201,300
Semi-Commercial, Industrial, etc.	57,410,000
Clubs, Churches, Hospitals, etc.	80,303,150
Total	$1,016,289,600

There is a considerable difference in the type of financing carried out by different houses specializing in this field. Thus, firms like S. W. Straus & Company, who currently do the largest volume of business among such companies, sell bonds representing a fractional interest in a large commercial building or apartment house mortgage, but stress their own sponsorship of the bond rather than the intrinsic value of the underlying security. This house has taken over the management of several properties whose owners were not able to meet interest requirements, and the bondholders have therefore not suffered any loss through the inadequate income of such properties, the deficit being met by the Straus firm. Of course, no formal guarantee that this will be done is made.

In other cases, urban real estate financing firms have tried the selling of preferred and common stocks instead of bonds. The largest attempt of the kind has been made in New York City by the Fred F. French companies, which place a 50-percent first mortgage on a large building which they themselves construct and operate, and then sell preferred stock to cover the balance of the cost. The financing company then keeps half the common stock equity, giving the other half to the preferred stockholders. In effect, this results in giving investors a preferred stock in place of a mortgage, and the decreased security is offset by the common stock equity.

A number of firms have also entered the second mortgage field. Rates on second mortgages naturally run quite high, and therefore this business, involving a much greater risk than the first mortgage financing, gives a considerably higher margin of profit to the mortgage company handling the deals.

Building and Loan Associations

The financing of individual home building is being carried on currently to a large extent through the application of the coöperative principle by the building and loan association. This form of institution, first started in 1831, has enjoyed a spectacular growth in recent years, as is evidenced by the following statistics:

Year	Number of associations	Total number of members	Total assets (000 omitted)
1900..................	5,490	1,495,136	$ 614,119
1910..................	5,937	2,216,912	945,569
1920..................	8,624	5,026,781	2,534,320
1925..................	12,403	9,886,997	5,509,176
1927..................	12,804	11,336,261	7,178,562

Building and loan associations operate according to several different plans. The general purpose in each case is to pool the funds of many persons and utilize the proceeds to finance the construction of homes by the purchase of first mortgages. This is done through the issuance of shares, upon which members are required to make regular weekly or monthly installment payments. These payments then receive a compound rate of dividend, so that the shares become fully paid up at their face value within a relatively short period of time. Thus, if 6-per-cent dividends are allowed, payments of $5 monthly will pay for one $1,000 share in full within less than twelve years, although aggregate actual payments during this period amount to little over $700.

In making loans, the association investigates through a loan committee of directors or officers. In many states, only members of the association may secure loans, the mutual principle thus being maintained. The funds available in the hands of the association at any one time are, of course, limited; and preference may be accorded in the order of the time of receipt of loan applications. Many associations, when their funds are insufficient to meet applications, grant loans first to borrowers who offer a premium above the usual interest rate for the privilege. Funds for lending come both from payments on shares by members and from repayments of old loans, many associations providing for the amortization of mortgage loans within a period of twelve years. Loans may also be made against the shares as collateral up to 80 or 90 per cent of their paid-in value. These "stock loans" are usually for shorter periods.

Several methods are provided in different associations for the repayment of mortgage loans. Members generally may use their matured shares to pay off their loans, although an option is frequently provided whereby the loan may be paid off in cash, the member retaining his shares as an investment. In other cases, periodical repayment of the loan by small weekly or monthly installments is provided, separating the share-holding and borrowing operations.

While originally organized solely for the purpose of coöperating financing of home building, the building and loan associations in their later development have tended to an increasing degree to become savings institutions of a general character as well. Many of them, especially the larger ones, make a special effort to acquire investor members who join merely because they can thus get a higher rate of return than that afforded by savings banks. When the associations then find they cannot properly invest all the funds they receive, they generally invest such excess in securities, and in this way many of them have become substantial buyers of high-grade bonds.

The past record of the building and loan associations has been good in most states, although there have been a moderate number of failures, at times because of bad management and in a few instances because of decidedly unfavorable real estate conditions in certain localities. Operating in small units and as a rule in one restricted area, many of them fail to achieve an adequate diversification of risk. Most states have passed laws for regulating these associations which provide for periodical examination of their financial condition.

Growth of Mortgage Banking

The growth of mortgage banking is shown by the figures already given in connection with issues of land mortgage bonds in the United States. Mortgage banks were badly retarded in Europe by the war; and while mortgage banking organizations did not suffer the severe handicaps under which many other financial enterprises labored, they, in common with others, felt the effects of the war and of the disorganization of the social and financial structures which accompanied it. From the opening of the struggle in 1914, therefore, up to the present time, the development of European mortgage banking showed a hiatus; and it is to the United States which, during those same years, has enjoyed the greatest banking development in its history, that we must look as a true indicator of progress in this connection.

So far as relates to the development of mortgage banking in the cities, in the sense in which the term is used in this discussion, the figures below,[1] designed to show the estimated total of city real estate bonds during a two-year period compared with public utility and railroad bonds, will furnish the information. The data are necessarily incomplete, and, more-

[1] Real Estate Financing by Months Compared

	1926 Real Estate	1927 Real Estate	1927 Public Utilities	1927 Railroads
January	$ 87,067,000	$ 96,163,500	$ 207,934,000	$ 13,396,000
February	68,282,000	78,268,700	176,845,000	125,072,000
March	73,270,000	79,295,500	122,835,000	91,981,000
April	71,835,000	91,844,750	140,706,000	18,925,000
May	77,085,000	79,003,000	182,957,000	79,835,000
June	89,246,850	105,155,250	131,576,000	47,441,000
July	79,659,500	90,024,500	92,000,000	1,650,000
August	67,435,000	69,983,850	76,527,000	96,852,000
September	72,895,000	81,328,000	137,562,000	14,943,000
October	71,582,000	77,357,550	264,746,000	32,549,500
November	73,391,000	77,880,950	187,546,000	12,856,000
December	74,350,000	89,984,050	325,275,000	73,686,000
Total	$906,098,350	$1,016,289,600	$2,046,509,000	$609,186,500

over, cover a period too short to afford a basis for final inferences regarding the speed or scope of the development to be expected in the early future. However, a fairly confident prediction may be hazarded that these institutions will continue their growth, and will serve as the chief means of financing the continued rapid development of American cities.

It is interesting also to compare the totals thus shown for recent years with the previous growth of real estate securities during the past decade, as follows:

1919	$ 57,458,000
1920	77,484,000
1921	49,786,500
1922	160,056,000
1923	239,363,000
1924	322,473,000
1925	695,556,000
1926	906,098,350
1927	1,016,289,600

The latest developments in the process of popularizing real estate securities are seen in the progress of efforts designed to give to such securities a readier market than heretofore and hence to endow them with at least some quality of liquidity. There is no reason why real estate bonds should not be given a much quicker and broader market than is afforded through over-the-counter trading by a few dealers. These securities would naturally conform much more closely to changes in the money market than they can be expected to do under present conditions of unorganized trading. When these requirements have been fully worked out, it is difficult to see why mortgage bonds should not attain the same general marketability that is possessed by other bonds of a similar grade; while much greater discrimination can then be exercised in valuing and in recognizing differences in worth between the various issues of such securities.

However, it must be remembered that the institutional market is still the chief reliance of the sellers of real estate mortgages. Life insurance companies hold over $6,250,000,000 in mortgages. Saving banks in 1929 held approximately $5,000,000,000 of realty mortgages, chiefly in the cities. Commercial banks of all classes held about $3,000,000,000. Building and loan associations, as has been seen, had some $7,000,000,000 to dispose of in this way. On the other hand, the 400 leading mortgage companies in 40 different states reported there were outstanding an aggregate of $5,000,000,000 of real estate securities sold by them in that same year.

Fundamental Principles

Some fundamental principles of mortgage banking may now be discussed. It will have been noted that the essential idea underlying the whole enterprise is the notion of diversification of risk. This use of the principle of diversification is sometimes spoken or thought of as being a means of spreading out and minimizing losses. It cannot be too strongly insisted that careful mortgage banking is at bottom in the main a means of avoiding dangerous investments and of preventing losses.

One of its characteristics, wherever it has been successfully applied, has been seen in the constant and careful testing of offered loans, the comparison of the basis upon which they rest with the average or standard basis underlying all such loans, and the application of conservative analysis to the testing of conditions under which new capital is being applied and yields obtained from it. Unquestionably, as mortgage banking grows more and more perfect, this phase of its activity will be further worked out.

The diversification that underlies it in its rural aspect is a geographic diversification, designed to give to the buyer a security of average high quality secured by a uniform type of underlying protection. In order to get this kind of average protection, certain standard ideas should be observed in the process of lending. They are in general as follows: (1) The use of a satisfactory criterion of the purpose for which the loan is to be made, *e.g.*, to improve the fertility of a piece of soil by draining, fertilizing or otherwise cultivating it; (2) the application of a careful plan of amortization designed to subtract from the annual yield of the land the proportionate share which represents the economic earning for that period of the new capital invested; (3) the standardization of the title, the mortgage, and other underlying papers so as to eliminate legal controversy or proceedings; (4) the classification of the mortgages behind any issue of bonds in series of relatively uniform maturity and, so far as possible, somewhat similar size; (5) the standardization of the bonds issued against the mortgages, and the provision of utmost safeguards designed to insure collectibility and to provide the holder with his interest at the smallest expense. All of these principles are well recognized and widely known, and there is no reason why they should not be accepted without question in any agricultural land-bond plan. The result should be a good standard security appealing to a large group of investors and enabling them to furnish money upon terms which should considerably cut down the farmers' expenses for capital.

The principles of sound city real estate financing are not materially different from those which are applied to rural operations, except in so far as is necessary by reason of the underlying economic differences in the character of the work to be done. What has been said about the necessity of careful amortization, standardization and the like, both as applied to the mortgage and accompanying documents and to the bonds, holds true of city real estate financing, as it does of agricultural borrowing. The chief difference between the two types of operation is found in connection with the study of the underlying security. Of course, in rural lending, as in city financing, it is essentially necessary to have a sound appraisal of the value of the mortgaged property. In the country, the appraisal has a definite economic basis which is furnished by the use to which the land can be put and the gross earnings that can be made through such use. A piece of land, for example, may be satisfactory for the cultivation of both corn and wheat. One of the two crops is usually the more profitable, and the amount which can be harvested from it over a series of years furnishes, on the average, the test of its income-producing power and, therefore, the ultimate test of the amount which may safely be lent upon it. A different test is necessary in the city.

This test is furnished by the rental capacity of the city building, and this rental capacity is a complex matter which involves questions of the management of the structure, changing currents of trade and of population in urban centers, and many other elements. It is necessary also to remember that, whereas the value of land is determined by broad general economic factors which underlie the question of demand for farm products and the prices of such products, the value of a city structure is dependent upon conditions affecting building costs, and is altered by fashions in building, new methods of meeting the convenience of occupants of offices, and a variety of other elements. All this may be summed up by saying that the problem of city real estate financing is not, as in the country, largely a matter of appraisal based upon ability to produce articles having a wide market, but is appraisal based upon capacity to sell a highly localized and special service—the provision of space.

The conditions under which general mortgages are created, and under which bonds representing either groups of mortgages or participation in a single large mortgage are distributed, are the same in the two cases. It is only the difference in technique and method which warrants the segregation of rural credit and of city mortgage banking, as between two distinct phases or types of the general subject of mortgage banking. Most mortgage bankers prefer to confine their operations to one or the other class of loans and do not feel it wise to attempt a combination. Indeed, there are many instances in which city mortgage bankers have come to specialize more closely within even this already specialized field. Not a few of them tend to confine their financing to office buildings and commercial structures, while they leave to other institutions the process of financing residential construction. There is further specialization between the financing of individual houses on the one hand, and apartment houses on the other. But such specialization is really the outgrowth of specialization of investment demand or of the fact that a highly specialized technique has become essential in appraisal, so that better results are attained by confining operations rather narrowly instead of allowing them to spread out over too great a diversity of mortgage loans.

General Service of Mortgage Banking

From this sketch of the mortgage banking situation, it is easy to recognize the essential place it occupies in the investment field. It truly performs the function of bringing together capital and opportunity in a particular branch of industry—that of improving the soil or of adding to it capital improvements in the form of buildings. It finds its chief financial function in developing groups of savers and investors who prefer this particular kind of security, and who are willing therefore to furnish the means for larger exploitation of natural resources through this means. Again, the service of investment banking in this field is seen in the fact that it has been possible to place capital obligations in tangible form in round amounts and thus make them available for buyers in a shape that is much more acceptable than the actual mortgages themselves would be.

The relation of mortgage banking to other types of investment institution is becoming of increasing importance. Hitherto a specialized market for mortgages has been developed and the great buyers of such securities have been savings banks, commercial banks, insurance companies, title companies, and others which had special facilities for testing and judging of the qualities of the mortgages offered to them. Thus it sometimes happened that such institutions have constituted so nearly exclusive a market for loans of that type as to enable them to fix rates of interest within very well-defined limits so that the borrower, with some degree of justice, sometimes felt that he was in the grasp of a "trust." The general application of the mortgage banking principle will gradually help to end this kind of complaint, and will distribute mortgage investments more and more widely over a far larger field of investment.

There may thus be a tendency to eliminate a considerable portion of mortgage loans from the portfolios of the institutions which have thus far carried them, and they in turn will find it necessary to look elsewhere for their investments or to substitute for direct mortgages the mortgage bonds which are gradually taking their place as a general or popular form of investment. The result should be a decided strengthening of the portfolios of investment institutions, and at the same time a smoothing out of the inequalities of interest rates. This change should prove beneficial to the institutions themselves by giving them a better and more widely diversified portfolio, while it should also give to the borrower on mortgage a rate of interest much more closely in accordance with the general market rate prevailing at the time he obtains his loan.

It so happens that in most communities land and the structures built upon it have come to be regarded as a fundamental object of taxation. Some economists indeed have been inclined to urge that they should be the chief, if not the only, basis and measure of taxation. Few would go so far today; but as a matter of practice as well as of theory, land and its improvements do constitute a well-nigh universal tax basis On the other hand, many governments have given to real estate bonds a preferred taxable status, as in fact our federal government has determined to do in the case of its farm land bonds and of the bonds of joint stock land banks. In consequence, rates of interest upon bonds which are thus preferred naturally tend to go lower in the degree to which they enjoy tax exemption, and they thus become more suitable as investments for persons who profit most from such tax exemption.

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Chapter VII

HISTORY OF AMERICAN INVESTMENT BANKING

The Lesson of History

Students of commercial banking generally devote much study to an examination of the development of the present banking system of the United States. Such an examination, it is usually felt, is of value in understanding many features of our present system not otherwise clearly grasped. Furthermore, banking history has been of special value in connection with any proposals for changes in our banking laws or practices, since many a proposal now advanced has been tested in one form or another in the past.

The same is true of the history of investment banking. The issue and sale of securities have been carried on in this country since colonial days, and many changes have occurred in the methods which have been followed and in the institutions devised to accomplish these transactions. The process of evolution of an investment banking mechanism, fully articulated and adequate for the unprecedented and growing capital needs of this country and its debtor nations, is now going forward at a more rapid pace than ever before, and the experience of the past is also of value here in guiding further changes which are being made from year to year in investment banking practice. By revealing their causes and historical setting, such study may also disclose many unnecessary and outworn features of our present organization and laws, and thus help lead to their elimination.

The reason why currency and commercial banking history have been carefully analyzed, to the neglect of investment banking, lies partly in the great political interest attaching to these questions, and partly in their dominating importance in the early financial life of the country. Investment banking problems are of later growth, and not until recent years have they affected more than a small percentage of the population. Hence, this is a relatively virgin field, in which much study will be necessary before the full significance of the many changes which have taken place can be clearly realized.

The Beginnings

The first investment banking activities known in this country were the abortive efforts to establish mortgage banks in several of the thirteen colonies before the Revolution. The basic distinction between commercial and investment banking operations was to be learned in our banking history at so great a cost that the lesson was learned perhaps too well, with the result that our laws at times have distinguished between the two kinds of activity to an exaggerated extent. But this was not so in the early days, and the colonists, eager for cheap money in quantity, sought to develop mortgage banks which would issue currency to them in return for mortgages on their farms. As one recent student of early banking theory says, "The earliest sentiment seems to have been that banks should serve all classes alike with their loans, regardless of whether or not liquid assets result." [1] The early state banks, even after the Revolution, were expected to advance long-term loans to farmers. The charter of a bank in Massachusetts established in 1792, for example, required that one-fifth of the loans be reserved for the benefit of "the agricultural interest." [2] This was in conservative New England. The southern and western states went much further in a similar direction.

No investment banking mechanism existed for those few colonists who did not employ their wealth directly. Local real estate or a share in a ship were the chief forms of private investment, and these were generally purchased directly, without the aid of any intermediary.

The first major financial operations to take place in this country had to do with the financing of the Revolutionary War. The original thirteen colonies were primarily agricultural communities, industry having been restricted by the British laws so that whatever activities of this kind flourished were on a

[1] Miller, H. E., *Banking Theories in the United States before 1860*, p. 171.
[2] *Massachusetts Acts and Resolves, 1792-1793*, p. 18.

small scale, involving very little fixed capital. Several fortunes were built up on the basis of the shipping trade, with or without the aid of smuggling, but they were not numerous before the Revolution. Manufacturing activity was all but non-existent.

The revolutionary government was in great need of money, and it incurred a bonded debt of several millions, in addition to issuing a mass of currency which later became practically worthless. It borrowed money at home chiefly through Robert Morris, a wealthy Philadelphia shipping magnate who became banker and commissary for the armies in the field. It sent Dr. Benjamin Franklin abroad, and he borrowed substantial sums in Paris and Holland, giving bonds of the government in exchange for much-needed supplies. In this way a debt of $11,-710,000 was gradually accumulated abroad, and one of over $40,000,000 at home, including accrued and unpaid interest.[1] The domestic debt was partly incurred originally by the states. These debts were all recognized by the constitutional government, and were exchanged for 6- and 3-per-cent bonds on a fixed basis in Hamilton's funding scheme. Although calling for some concessions from the bondholders, Hamilton's proposals were so much better than had been expected that they served to establish the credit of the United States, and resulted in the first extensive security speculation known in this country, consisting of a rapid rise in the old bonds to discount the unexpectedly favorable treatment they received at the hands of the new government.

From the close of the Revolution it was realized that a central bank was needed to regulate the currency and aid in the government finance of the republic. Hamilton's original thought on the subject was that a land mortgage bank was needed; but by 1790, when his celebrated report was handed to Congress, he had apparently grasped the distinction between investment and commercial banking. He advocated the restriction of the new bank to the latter field, except for government financing; and Clause X of the bank's charter restricted its dealings to bills of exchange and gold or silver bullion.

That the accumulation of capital within the country was

[1] Channing, Edward, *History of the United States*, vol. iv, p. 95.

already going on at a fairly rapid pace, partly from profits earned through supplying the army during the war and the removal of trade restrictions following its close, is clearly evident. The $8,000,000 capital of the first Bank of the United States was offered publicly, and over-subscribed within two hours. However, part of this stock quickly found its way to England, which was now rapidly forging ahead to the forefront among the capital markets of the world. The Industrial Revolution was then shifting the dominance in international finance from Holland to London, and it is noteworthy that the United States Revolutionary bonds which were sold originally in France and Holland were partly absorbed by London after 1790.[1] Following the reëstablishment of British confidence in this country which followed the organization of the constitutional government and the adoption of Hamilton's funding scheme, the London banking world took a growing interest in the infant republic.

The wave of security speculation which accompanied Hamilton's funding scheme and the formation of the First Bank of the United States resulted in the formation of small groups of brokers in Philadelphia and New York who specialized in executing purchases and sales for others. In New York these brokers would foregather in Wall Street; and by 1792 we find twenty-four of them signing an agreement to maintain a uniform commission of one-quarter of one per cent of the selling price of the shares, and to give preference to each other in their leadings. This agreement was meant to prevent the competition of commodity auction houses in the security business, and marked the beginnings of organized brokerage activities.

Early Period of Capital Accumulation (1790-1817)

The Napoleonic Wars in Europe led to a boom in the foreign trade of the United States which resulted in a fairly rapid accumulation of wealth in the seaboard cities of Philadelphia, New York, Boston and Baltimore. In each of these towns, a class of wealthy traders and shipowners arose who had a

[1] In 1791, Bird, Savage & Company, London stockbrokers, bought several million dollars' worth of these bonds in Holland and disposed of them to customers in London.

surplus of capital and so were in a position to purchase securities for the purpose of financing larger enterprises.

The capital market which thus came into being was not, however, adequate at first to permit the sale of any large issue of securities. The supply of funds available for the purchase of securities down to the last years of the Napoleonic Wars was not more than several million dollars annually. When any important need for large sums of money arose, foreign sources still had to be tapped. The $15,000,000 needed to finance the Louisiana Purchase in 1803 was raised chiefly in Holland. As late as 1805, the house of Baring in London, as agent there for the United States government, paid the coupons on United States government bonds of a par value of $28,500,000. When the federal government wished to dispose of its remaining holdings in the First Bank of the United States in 1802, it sold them to the Barings in one block of 2,220 shares.[1]

The situation changed when the European wars reached a more advanced stage. The more rapid accumulation of capital within this country that followed, and the simultaneous rise in money rates abroad caused by the great conflict, resulted in the gradual repatriation of both government bonds and shares in the Bank of the United States. This process was hastened by the steady redemption of the government debt, and the liquidation of the first Bank of the United States in 1812.

The accumulation of capital and the growth of trade resulted in the formation of a number of banks and insurance companies. By 1801 there had been formed twenty-three banks, with a combined capital of $35,550,000. The primitive condition of the country, the preponderant importance of trade, and the requirements of state laws caused these banks to restrict their activities almost entirely to purely commercial banking transactions. Thus, the Bank of New York, founded in 1784, was specifically forbidden to trade in stocks of the federal or state governments, or to lend on the security of real estate.

The banks in the commercial communities of the East tended to conform to Adam Smith's dictum, that a bank was to ad-

[1] Jenks, L. H., *The Migration of British Capital to 1875*, p. 66. This work may be regarded as the definitive account of Anglo-American finance before the Civil War.

vance only that part of the capital of a merchant "which he would otherwise be obliged to keep by him, unemployed, and in ready money, for answering occasional demands." The British idea of strictly commercial banking was not followed in the agricultural areas to the West and South, where strictly commercial loans were much scarcer. But with the increase in wealth and the development of a spirit of speculation, the line

Prices of Stocks

6 per Cent. Funded Debt	98¾ per cent.
3 per Cent. do do	56½ a 57
8 per Cent. Loan	112½
6 per Cent. Navy Loan	par

Bank Stock

United States Bank	143 a 143½ p. ct.
New York (dividend off)	131½
Manhattan	132

Insurance Shares

New York Insurance Co.	128 per cent.
Columbian ditto	137 a 138
United ditto	118 a 119

Bills of Exchange at 60 days sight

On London	100 a 101 per cent.
On Hamburgh	36 a 38 cts. p. mk. b.
On Amsterdam	40 cents per guilder

E. Benjamin, Stock and Exchange Broker,
No. 50 Wall Street.

November 14.

Figure 7. Advertisement of stock quotations appearing in the *Evening Post*, New York, November 16, 1801.

of demarcation between commercial and investment banking was still further broken down in the period which followed. In 1816, the first mutual savings bank was established in New York State as a purely investment institution, and this type of institution, which fostered small savings, showed a slow but steady growth thereafter.

In addition to bank and some insurance company flotations, there were canal and turnpike promotions. Davis reports 328 individual incorporations in all were formed before 1800, the great majority of them for small local improvement projects.[1] A great number, however, remained paper projects.

The methods of raising capital were primitive because no investment banking mechanism existed. The shares in these enterprises were as a rule offered directly to the public at some tavern or other public meeting place. There the investor would appear in person, and his name and the number of shares desired would be inscribed in great "books," which still lead a figurative existence in the terminology of Wall Street today. After the original flotation of the shares in this way, those of the larger companies attracted the interest of brokers, who often gave their quotations for publication to the newspapers and periodicals of the time. In order to acquire securities for sale, these brokers would at times subscribe for new issues in their own names. A typical list of quotations, taken from the New York *Evening Post* of 1801, is shown in Fig. 7.

The first formal stock exchange to be opened in this country was organized in Philadelphia in 1800. Philadelphia was the commercial and financial metropolis at the close of the Revolution, and it retained its financial primacy practically down to the War of 1812, although it lost its trade leadership a decade earlier. In New York, after the speculation in governments in the early 'nineties came to a close, the security market became very restricted, and many of the brokers turned their attention to other affairs. In fact, it was not until 1817 that the New York Stock Exchange was formally organized and a written constitution adopted.[2]

The War of 1812 had to be financed entirely at home. The government's efforts to raise money were attended by the greatest difficulties, to a large extent because of the sharp division of opinion as to the wisdom of the conflict and the failure to recharter the First Bank of the United States. However, the war did show that capital accumulation had proceeded to a point where large sums could be raised in the domestic market. When in 1813, with bankruptcy staring it in the face, the Treasury asked for $16,000,000, the public bought only

[1] Davis, Joseph S., *Essays in the Earlier History of American Corporations,* pp. 24 ff.

[2] Stedman, E. C., *The New York Stock Exchange,* pp. 62 ff.

about $6,000,000 of its bonds. Secretary Gallatin then called in the three leading capitalists of the day, Stephen Girard, John Jacob Astor and David Parish, and they took the remaining 6-per-cent bonds at approximately 88 per cent of par.[1] Similarly, the sale of the $35,000,000 of capital stock of the Second Bank of the United States, also through direct public offering, was successfully accomplished with the aid of the large fortunes of the day in 1816. A balance of more than $3,000,000 of the stock of the institution not taken by the public was subscribed for in one block by Stephen Girard.

Internal Improvements and the Import of Capital (1817-1840)

Following the close of the War of 1812, three important factors combined to change investment banking conditions in this country radically. In the first place, a mania for internal improvements arose which created a need for large amounts of capital far in excess of visible supplies, whereas previously the accumulation of capital here seemed to equal domestic requirements. In the second place, the close of the war in Europe resulted in a surplus of capital in England which eagerly sought the higher rates of return available abroad. In the third place, nascent industrial development in New England and other seaboard areas, and the opening up of new areas across the Appalachians, sharply reduced the supply of free capital within the country available to finance the internal improvement program.

The period of internal improvements was ushered in by the phenomenal success of the Erie Canal. Financed through the sale of state bonds, at first sold to Albany banks, this enterprise paid for itself from the start. The great increase in commerce and wealth it brought the City and State of New York resulted in a host of projects by other states to imitate it. The other states, like New York, were ready to back these projects with their own credit.

Conditions were peculiarly favorable at the time for the attracting of British capital to this country. In the first place, the rapid repayment of the national debt of the United States

[1] "National Finances," *Bankers' Magazine*, vol. i, p. 257.

after the close of the War of 1812 tended to create confidence. Secondly, Hamilton had taken over the state debts after the Revolution, and there was a strong tendency to ascribe to the states on this account approximately the same credit standing as that possessed by the federal government. Thirdly, the leading banking house in London was closely affiliated with American finance, and helped to confirm the already favorable attitude of the English investors toward their Anglo-Saxon cousins across the seas.

The house of Baring Brothers & Company was to play the chief rôle in the drama which followed. Originally wool manufacturers from Bremen, this family turned their interests to trade to an increasing extent during the eighteenth century. Alexander Baring late in the century allied himself by marriage with the wealthy Bingham family of Philadelphia, which both added largely to his wealth and centered his attention upon the United States. When the Napoleonic Wars came to a close, not even the Rothschilds had the prestige and wealth possessed by the Barings in England, and the firm was foremost in the financing of American trade and, later, the American states.

About 1817, British purchases of American securities began to take on sizable proportions. Two years later, an observer writes that this practice already was "of many years' standing, and therefore escapes observation."[1] New York State issued $7,000,000 of its bonds between 1817 and 1825 to finance the construction of the Erie Canal, and these bonds rapidly found their way to London. New York 6's appeared there in quantity in 1817, and were officially quoted on the London Stock Exchange in that year. A great stimulus was given to British investments here by the collapse of South American securities on the London market in 1825. This brought into vogue "reproductive investments," and within this classification American state and municipal bonds issued for internal improvements had a foremost place.

By 1836, there had been invested $90,000,000 in canals and railways in the northern states. More than half of this sum was raised through the pledging of state credit and the sale

[1] *Niles Register*, vol. xlv, p. 178.

of bonds in England. In addition, the southern states borrowed for both internal improvements and, more especially, land mortgage banks, since the plantation system in the South created capital needs for the purchase of slaves, etc. The British also held about that time $14,000,000 in federal government bonds and $8,000,000 in United States Bank stock, as well as substantial tracts of land for speculative appreciation.

It is highly significant that the British favored public securities, and shares of institutions like the Bank of the United States, in which foreign shareholders had no right to vote. Had they insisted and developed a suitable organization for the purpose, the British might have secured control of the railroads and other large enterprises then initiated in much the same way as they have subsequently in South America and other parts of the world. In Argentina, the great bulk of the railroads and public utilities, and many of the large agricultural and business enterprises, are directed from London. But despite large imports of capital made by the United States at various times in its history, actual ownership and operation of its leading enterprises have, with very few and minor exceptions, been retained by American citizens. The British in this early period did buy the bonds of a few railroads in the East and the stock of a few New York and New Orleans banks, and some mining shares. But the aggregate of these was small, and the only substantial institution which they controlled was the Bank of the Manhattan Company, which the Marquis of Carmarthen was said to own "body and breeches," except for directors' qualifying shares, for its board had to be composed of citizens of New York. This provision in the charter probably hastened the later repatriation of the ownership of this financial institution.

The Machinery for the Import of Capital

The investment banking mechanism which was created to finance the internal improvement program at home and abroad was relatively simple. There were practically no public offerings through underwriters. The state and municipal bonds were generally sold here through commissioners, appointed by state governments, who acted as agents and solicited bids, or by contract to merchants or bankers. Thus they were originally American issues, although they often contained provisions for the payment of the coupons in London at a fixed rate of exchange at the option of the holder. Large blocks of bonds were purchased in this way in New York at various times by Astor & Sons, by the leading brokerage house of Prime, Ward & King,[1] and by such banks as the Morris Canal & Banking Company and the Bank of the Manhattan Company.

These bonds were then sent abroad in large amounts to build up balances upon which these American bankers could draw to help pay for our imports. The financing of American trade was gradually concentrated in the hands of a small number of large merchants and banking houses. The Yankee dry-goods houses were especially prominent in this connection, and many of them gradually developed a substantial banking business as an offshoot of their trading operations. In order to build up balances in London against which they could draw in order to make payments for their purchases both in Europe and the Far East, where the United States had a heavy import excess, these houses remitted large blocks of these state securities. They were sent to the leading London banking houses, who is turn distributed them "to favored country banks for distribution to favored clients."[2]

A marked change took place in the method by which American securities were distributed to English investors after 1836. In that year, the charter of the Second Bank of the United States expired and was not renewed. This institution, with a capital of $35,000,000, was then transformed into a Pennsylvania corporation, and its business was modified to include a number of investment banking transactions found necessary to secure full employment for the large capital. An agency was opened in London, and Nicholas Biddle, the president, began to bid for entire issues of American securities, which he sent to his London agency for disposal there. In fact, the avowed purpose of the opening of this agency was to "popularize American securities," which were in turn to be sold

[1] Nathaniel Prime was regarded as the first real private banker in the city. See "Banking in New York, 1822-1922," issued by the Farmers' Loan & Trust Company.

[2] Jenks, *op. cit.*, p. 78.

abroad in order to maintain the speculative structure at home. This had been badly shaken by the panic of 1837 and Jackson's insistence on specie payments for sales of public lands, then taking place on a large scale for speculative purposes. The agency became the chief channel for the raising of investment capital abroad for the United States.

By thus providing the means for meeting indebtedness incurred by this country abroad on account of imports of merchandise and interest payments due, Biddle succeeded in keeping the bubble of internal improvements and speculation, accompanied by the wholesale issue of new indebtedness, inflated for several years more. In the end, the Bank of the United States was hopelessly bankrupt, and simultaneously, in 1841 and 1842, nine states stopped payment of interest on their indebtedness.

As an example of the way in which capital was raised for American use in this period, the case of the $5,000,000 Mississippi bond issue may be cited. In 1838, the State of Mississippi decided to establish a mortgage bank to aid planters, and it subscribed for the stock of the institution, paying with $5,000,000 of its bonds. Three commissioners were then designated by the directors of the bank to sell these bonds in order to raise liquid capital for the bank. They negotiated with Nicholas Biddle for the sale of the entire amount. The bonds were made payable at the agency of the Bank of the United States in London, thus facilitating their sale to British investors. Mr. Biddle promised to pay for the issue in five annual installments. The Bank of the United States in the meanwhile used these bonds in Europe as collateral for loans which it obtained from such leading bankers as Hope & Company of Amsterdam. The bonds were gradually sold in England, although Biddle never succeeded in selling the entire issue.

Within less than two years, it is interesting to note, the Mississippi bank was hopelessly insolvent because of the rash manner in which it made its loans. The state shortly thereafter repudiated the bonds, charging that a number of technicalities in the enabling act had not been complied with.[1]

The example of the Bank of the United States in establishing direct ties between the American borrowers and the London

[1] "The Origin of Repudiation," *Bankers' Magazine*, vol. i, p. 337.

capital market was followed by others. George Peabody, a Yankee dry-goods merchant, went to London and founded the house which later became Morgan, Grenfell & Company in 1837, to specialize in Maryland securities. The Rothschilds sent August Belmont to make his headquarters in New York as their personal representative. The French house of Hottinguer, also interested in American securities, sent a representative to this country who coöperated closely with Biddle. Finally, many Americans went overseas to negotiate loans directly for a commission.

The Domestic Capital Market

In the meanwhile, the accumulation of capital within this country went on, and the home money market began to assume sizable proportions. Foreign capital did not play any significant part in the financing of American manufacturing industries, such as the textile mills of New England and the iron manufacturies of Pennsylvania. In the first place, the British were not accustomed to joint stock industrial companies, having practically none of these in their own market at that time. Secondly, the British merchant bankers, who were also engaged to a large extent in exporting manufactured products to the United States, did not relish fostering competition here. As a result, American industry remained independent of foreign capital, a fact which was fraught with great significance for the future. Another factor was that British houses which would have been likely to take over control of industries here, such as the Rothschilds, did not play an important rôle in financing the United States. Until 1835, the Rothschilds, the "bankers of legitimacy" as they were called, refused to have anything to do with the new republic, which they regarded askance as a revolutionary affair.

In the 'thirties, the American capital market consisted of a number of moneyed families in the seaboard cities, a group of insurance companies in the leading cities, the banks which were springing up everywhere and, finally, a growing class of merchants and manufacturers who invested in relatively small amounts and appeared at the time to favor stocks in railroads and financial institutions. The latter class constituted the chief clients of the brokers who were then building up exchanges in the leading centers.

A compilation made in 1831 showed that in New York City alone there were sixteen banks with a combined capital of $18,130,000, eight marine insurance companies with a capital of $3,050,000, and twenty-five fire insurance companies with a capital of $7,800,000. Boston, which had forged ahead to second place in financial importance, had eighteen banks with a capital of $13,900,000, and Philadelphia had thirteen banks with a capital of $10,792,000. In arriving at these figures, each office of the Bank of the United States was allowed a capital of $1,500,000.[1]

The commercial banks exercised investment banking functions in two ways. First, they bought the new state and municipal securities in large blocks for their own account wherever their charters made this possible. Secondly, they made large loans to promoters and others on the security of stocks and bonds. The Bank of the United States did both on a large scale. It turned over entire issues of bonds which it sold or pawned in Europe, and it also loaned over $20,000,000 on the security of turnpike, canal, railroad and land companies, often directly to these companies themselves to help them to complete their projects. Numerous smaller banks—347 were chartered between 1830 and 1837—also sprang up, "willing to finance almost any conceivable proposal."[2] "Wildcat banking," in which the distinction between commercial and investment operations disappeared, was flourishing at this time.

The three years following the panic of 1837 closed a period of rapid internal development and widespread speculation throughout the country. During this period, a substantial capital market was developed for the first time, a number of canals and railways were built, and the frontier was pushed farther westward to the Mississippi.

The three least fortunate developments were the mania for speculative land purchases, the defaults on the debts of many of the states held abroad, and the spread of unsound banking methods. Many of the new banks, especially in the West and

[1] GODDARD, THOMAS H., *A General History of Banking.*
[2] McGRANE, R. C., *The Panic of 1837*, p. 17.

South, although designed as commercial banks, actually turned out to be land banks run on very unsound principles. In the "wildcat" days, banks were organized which sold their stock in return for real estate mortgages, and then utilized to the full their right under state law to issue currency up to two and one-half times the amount of their capital. In the seaboard states, however, a sounder view of the relation of the banks to the real estate market generally obtained, even during the speculative period. The general banking law of Massachusetts, first passed in 1829, stated that banks could not invest more than 12 per cent of their capital in real estate, including the banking premises.

The panic of 1837 and subsequent large losses suffered by banks through dealing in securities caused many states once again to seek a more rigid separation of commercial and investment banking. The spectacular failure of the Bank of the United States in 1841, in which it was found that the depreciation of its security holdings had wiped out its capital of $35,000,000, accentuated this tendency. Charters of banks organized in New York under the safety fund scheme provided invariably that the bank "shall not directly or indirectly deal or trade in . . . buying or selling any stock created under any act of the United States or any particular State, unless in selling the same when truly pledged by way of security for debts due." In commenting on this legal provision, the *Bankers' Magazine* said, "The object of the statute was doubtless to prevent banks from hazarding their capital, especially in stock jobbing, to which they are often strongly tempted, and from which disastrous consequences often follow." [1]

In the eastern cities, notably New York, call loan markets were already established, thus making the liquid funds of the banks the means of financing the holding of investment securities representing long-term commitments of capital. During the panic of 1837, when the drastic decline in securities made it impossible to realize on many such loans, they were severely criticized in the public press, although the practice was recognized as long-established, and therefore perhaps a necessary evil.

[1] *Bankers' Magazine,* vol. ii, p. 741.

Moreover, in this period there is already visible the beginning of a tendency to separate real estate financing from commercial banking and to concentrate it in specialized institutions. Thus in 1835, an Illinois lawyer, Francis B. Peabody by name, found his eastern clients so eager for sound mortgages on Illinois property that he opened a mortgage banking house, one of the first in the country, and certainly the first in the West.[1]

Recuperation and Growth (1840-1860)

With the cutting off of the supplies of foreign capital after the collapse of the second Bank of the United States in 1839 and the numerous defaults of the states in the same period, the growth of the country continued for a time at a slower pace, but also without the symptoms of exaggerated speculation which had marked the preceding era. The experience of the wildcat banks resulted in a general disposition to curtail banking activity, and especially to demarcate commercial and investment banking.

In the southern states, for example, where some of the worst examples of unsound banking had occurred, amendments were generally passed severely restricting investments by banks in real estate and securities. There was a general disposition to recognize the essential differences between banking with liquid and illiquid assets, and doubtless the experience of the panic period played an important rôle in making relatively complete the segregation of commercial and investment banking institutions in this country, which thereafter became a marked feature of American financial organization.

Railroad building attracted increasing interest during this era, but this time the banks did not play an important part in their development. Instead, a number of brokerage houses became specially interested in their securities, and these houses in several cases advanced money to the railroads and secured representation on the boards of directors as a result. Thus we find the firm of Drew, Robinson & Company active in this con-

[1] *Financing an Empire—History of Banking in Illinois*, pp. 536 ff. This firm has continued down to the present day in the house of Peabody, Smith & Company.

nection in the 'forties, the Drew being none other than Daniel Drew, who was to become the prototype of a new type of predatory financier twenty years later. Drew helped finance the Erie Railroad when it was being built across southern New York State, lending money on the collateral of its stock and convertible bonds, which he later took over in payment for the loan. In this way he secured a place on the board of directors of the company. Jacob Little shares with Drew the honor of founding a long line of predatory speculators. Another figure who was later to play an important rôle, Jay Gould, also appeared in Wall Street in the late 'fifties as head of a brokerage house interested in railroad securities.

The growing speculation in railroad and miscellaneous securities caused a rapid expansion of the exchanges. The following table traces the growth of the New York Stock Exchange, as shown by fragmentary data available:

Year	*Number of Brokers*	*Approximate Average Daily Turnover*
1817	20	Several shares
1820	39	" "
1827	..	100
1828	..	600
1830	..	1,000
1848	112	5,000

So great had speculative interest become, that a New Board of Brokers was founded as a separate exchange, which competed for a time with the original Old Board. The former gradually died out, however.

While the financial supremacy of New York was unquestioned after the early 'thirties, the other seaboard cities were often close competitors. Thus, in Philadelphia the house of E. W. Clark & Company financed the Mexican war, and the Philadelphia investment market rivaled that of New York in wealth and influence. This firm, as did that of Corcoran & Riggs in Washington, had great influence with rich investors and a substantial distribution power, and they played an important part in promoting new railroads and reorganizing bankrupt canal and railway companies.

In the late 'forties, European interest in American finance began to revive, but henceforth the foreign investor favored railroad securities issued by private corporations. August Schoenberg had come from Vienna in 1837 to establish an agency here for the Rothschilds, which developed into the international banking house of August Belmont & Company and played a leading rôle in directing a new flow of foreign capital into American enterprise. An official compilation made in 1854 clearly illustrates the relative importance of foreign holdings in each group of securities, outstanding.[1]

Security	Total outstanding	Foreign owned	Per cent foreign owned
United States government	$ 58,205,000	$ 27,000,000	46
States	190,718,000	110,972,000	58
Counties & cities	93,280,000	21,462,000	23
Railroad bonds	170,112,000	43,889,000	26
Railroad stocks	309,894,000	8,026,000	3
Banks & insurance	279,555,000	7,067,000	3
Canals & navigation	58,019,000	2,522,000	4
Miscellaneous	18,814,000	1,068,000	6
Total	$1,178,597,000	$222,006,000	18

In the years preceding the panic of 1857 speculation again became active, especially in stocks. The call money market developed enormously to keep pace with the demand for securities. The attitude of the time toward this feature of the market for securities, which facilitated the carrying of stocks for speculative purposes and made of such loans the most liquid investments available for the banks, is expressed in the following statement from the Report of the Massachusetts Banking Commissioners, handed down in 1855: "Extension upon the basis of business paper is a very different thing from distention created by speculation upon mere capital—that is,

[1] Secretary of the Treasury, *Report on Foreign Holdings of American Securities,* made to Congress.

loans upon stocks, instead of discounts of promises representing something that has an intrinsic value."

The free use of the call loan, which has been common since the period of internal improvements and bank incorporations that began with the War of 1812, has been a factor little appreciated in keeping the control of American industry within this country during the period when large imports of capital made it possible for foreign control to gain a strong foothold in the management of our industry. During this era, the foreign investor sought to minimize his risks at the very time that the American, fired with pioneer optimistic zeal, was ready to take more than an ordinary chance for a large profit. The free use of the call loan opened up to the speculator the means of easily financing his operations by making available to him on a low-cost basis the funds of the commercial banks, usually an ample source of liquid capital in the growing commercial and industrial communities of the seaboard cities.

A sequel to the rapid development of the call loan market was the evolution of the peculiar American system of daily settlements on the exchange. In the early days of the exchange, most transactions involved delivery of stock after an interval, usually up to 60 days. The average period of settlement tended to become shorter, and by 1857 daily settlements were formally adopted.

The Civil War and the Rise of the American Bond House

By the opening of the Civil War, the financing of the railroads and states and cities had created an investment banking machinery of substantial proportions. However, American investment banking practice was not then differentiated, as it was later to be, from methods pursued in other countries. Owing to the small clientele available for investment issues, they were sold through consultation by the investment banker with his client in the latter's office. The salesman, and other "high pressure" agents for achieving security distribution which characterized the further development of the business, were not yet in evidence. A radical change in the character of the investment banking business was to be brought about during the Civil War, just as another revolution in methods and size was to be accomplished by another war more than half a century later.

The development of investment middlemen here, as elsewhere, was a direct outgrowth of the practice of underwriting, or insuring, an issue of securities. Originally, as has been seen, new security issues were often offered directly by the company to the public. To avoid the uncertainty of the public response—especially in cases where the proceeds had been spent in advance on the property—the company turned to a banking or brokerage house and, for a fee, induced it to guarantee the sale of the issue, the unsold portion being taken up by the underwriters. There is but one step from this procedure to the outright purchase of the entire issue by the investment banker; in fact, the purchase of an issue of securities for subsequent resale is still called an underwriting operation, but the term is an anachronism for the modern method of bond issue. In England, new security issues are in fact frequently offered to the public by the issuing company, and the bankers merely appear as the underwriters who will take over only the unsold portion of the offering.

The sale of government bonds during the Civil War witnessed the first outburst of active bond selling in this country, although rudimentary cases existed during the preceding era of railroad promotion. The credit of the government was poor, and the European market, to which borrowers here had been in the custom of resorting for large bond issues, was unfriendly to the union cause. Accordingly, the Treasury was faced with the immediate necessity of creating a great market for government bonds. Jay Cooke, a Philadelphia banker trained in the old house of E. W. Clarke & Company, accomplished this task, and helped revolutionize the American investment banking business more than any other single individual. In 1861, he formed his own firm and joined with the older house of Drexel & Company in selling a $3,000,000 Pennsylvania State Loan at par, above the market price, through an appeal to patriotic principles. He then took an interest in the federal government bonds at that time appearing on the market in increasing quantities to finance the war. Already the market for them was showing signs of exhaustion, and grave fears were expressed concerning the ability of the government to continue to raise money. Jay Cooke achieved remarkable success in selling bonds locally through salesmen and with the aid of widespread advertising, and Secretary Chase finally appointed him Government Loan Sales Agent, in which capacity he directed the sale of federal bonds during the period of the conflict. He was the original bond salesman, the prototype of the thousands of men and women who now earn a living by selling securities. At one time, he alone employed 5,000 such salesmen.

Jay Cooke first developed many of the most prominent characteristics of American investment banking—developed them through the application to bond selling of the pioneer psychology which was evident in many other economic activities in this country. His methods have been graphically described by one biographer as follows:[1]

"Mr. Cooke's agents—he employed some five thousand during the second 'seven-thirty drive'—went everywhere. They overran the countryside visiting every hamlet and farm, appealing to every living person they could find. They distributed posters and circulars—broadsides some of them, with eagles and mothers on one side and popular songs on the back—in railroad stations, courthouses and hotels, in factories, in stores, in trains; they gave them to toll gate keepers, to postmasters, to the teamsters on the roads; they pasted them on walls, they put them up on trees, they tacked them on telegraph poles; and they interviewed newspaper editors."

Cooke was the first American financier to realize to the full the power of the press in finance, and to use it. From that day to this, the lesson he taught has been well learned and applied by a host of imitators. He won the favor of editors and writers by flattery, by threats, by dangling advertising contracts before them and by doing favors. In return, the news and editorial columns resounded with his name and with his message—the maximum purchase of government bonds by every individual in the country. And the result was that the Treasury was able to sell $2,000,000,000 of bonds during the war period. He was also the pioneer financial advertiser.

It may be asked why the number of security holders dwindled

[1] MINNIGERODE, MEADE, *Certain Rich Men*, pp. 65–66.

after Cooke's efforts ended; why the United States did not become right then and there a "nation of bondholders," a phrase much used sixty years later. The answer is that individual business opportunities were so great that capital was withdrawn from securities and put back into individual business enterprises—agricultural, industrial, and commercial—as soon as the war came to an end and pressure to purchase and hold bonds was removed. However, the dimensions of the permanent market for investment securities were greatly enlarged by Cooke's efforts, despite the contraction which followed the panic of 1873.

Next to Jay Cooke's management of the sale of government bonds, the most significant event of the Civil War from the investment banking viewpoint was the passage of the National Bank Act of 1862. Designed to furnish a sound and stable currency in the form of bond-secured bank notes, these national banks became, shortly after the war, the chief group of financial institutions in the country. Outside of their purchase of government bonds as note issue security, they were expected to restrict their activities to commercial banking. The law permitted them to negotiate "promissory notes, drafts, bills of exchange and other evidences of debt." It was only later that the Comptroller of the Currency ruled that "other evidences of debt" might include bonds.

The development of the investment banking business in this country after the Civil War may be divided into three great historical eras:

1. The period of railroad promotion
2. The period of industrial consolidation
3. The period of the export of capital and widespread popular security distribution

Railroad Building and Industrial Development—The Rise of the International Bankers (1865-1893)

The period from the end of the Civil War to the panic of 1893 was dominated by the rapid growth of our transportation network and the evolution of the great railroad systems. More than 30,000 miles of new track were laid between the close of the Civil War and the panic of 1873. These railroads were the cause for the rise of the United States to the first rank among agricultural exporting nations. This period also witnessed the coming of age of the American capital market, although at the same time some $2,000,000,000 of European capital is estimated to have been invested in this country, almost entirely in railroad securities.

Industrial development in this era was rapid, but it assumed largely the form of relatively small individual enterprises and local corporations, so that the industrials did not as yet play an important part in American finance. But this period of the growth of numerous small enterprises made possible its spectacular sequel, the combination and trust era. However, even in the 'eighties a few industrial combinations aiming at substantial monopoly power already appeared on the horizon—the oil, sugar and whiskey trusts. Also, the investment bankers were not important as yet in the industrial field. The more important combinations were then being evolved by the industrialists themselves—people like the Rockefellers in oil and the Havemeyers in sugar.

One outstanding exception to the rule was the exploitation of the copper resources of Michigan with Boston capital. The Boston exchange became the chief market for copper securities in the world in the 'seventies and 'eighties, and a number of banking houses were formed there to specialize in them. Several of these houses have survived as leading financial institutions down to the present day. For a time, it seemed that the financial capital of conservative New England was to become the most speculative market in the country, but enthusiasm gradually simmered down as the industry gained stability.

In the investment banking field, this period witnessed a curious evolution in the decline, after 1873, of the distributing houses built up during and directly after the Civil War, and the rise to dominance of the so-called international bankers, whose chief source of power was their foreign connections—their ability to sell American securities which they sponsored to bankers in England, Holland and Germany. Directly after the Civil War, Jay Cooke and a number of bond houses turned their energies to the financing of railroads. The financial press of that period is full of railroad offerings of such companies as the Northern Pacific, Chesapeake & Ohio, and what later became the New York, Ontario & Western. These issues were sponsored by houses with extensive sales forces, who often based their selling appeal on the superior yields in these securities over those offered by the government bonds they had originally sold to their clients. Municipal securities also were recommended by these houses, especially high-yielding issues of the southern and western states.

The panic of 1873, chiefly marked by the failure of Jay Cooke and his associated banks, was brought on by the collapse of several of the railroads which were being financed by the distributing houses. Jay Cooke, who sold Northern Pacific bonds "almost exclusively to persons who rely upon our recommendations rather than upon their own judgment," finally discovered that "there is a limit to this class and their money." Having tied up his own funds in an endeavor to finance the company pending the sale of its bonds, he was forced into bankruptcy when the road lost its credit. A number of the big distributing houses disappeared during the panic and subsequent depression, and in many cases the properties they originally financed came to look to the international bankers, with their access to wider capital markets, for funds.

The government loans of 1878 and 1879, issued in connection with the resumption of specie payments, were handled by a group of international bankers, of which August Belmont was the head. These transactions definitely established the pre-eminence of the international bankers. The rise of the international banking houses was accompanied by largely increased flotations abroad of American securities. This is illustrated in the following table (in millions of dollars) of offerings in the London market:[1]

Year	*U. S. Securities*	*State and Municipal*	*Railway*
1860–65	None	2	27.
1866–70	None	17	51.5
1871–75	800	40	275.

In addition, several relatively small utility and industrial issues were made in London after 1870.

[1] JENKS, L. H., *op. cit.*, p. 426.

Another characteristic of the period ending with the panic of 1873 was the appearance on the speculative markets, which had grown apace, especially under the stimulus of the easy money of the greenback régime, of a number of unscrupulous operators who acquired control of several American corporations through purchase of their shares on the open market. Daniel Drew, Jim Fisk and Jay Gould were the more conspicuous figures, and the latter continued on his course of successful speculative control of giant corporations, generally at the expense of the smaller stockholders and speculators, down to the end of the period. In individual instances, battles for control of railroads between these speculators and the international bankers were already occurring. The defeat of the speculator, however, was not finally accomplished until the panic of 1893.

A different type of promoter-operator was typified by Commodore Vanderbilt, who invested a fortune of $10,000,000 earned in the shipping business in railroads in the 'sixties, and within twenty years had increased his wealth tenfold through the purchase and consolidation of railroad properties. Vanderbilt ran his properties with at least one eye glued to the stock market, but he did not neglect to put these properties under efficient management and to make them highly useful, even if at times grasping and monopolistic, public servants. In his constructive efforts, he often came into bitter conflict with the speculators of the Gould type, who in the memorable battle over control of the Erie Railroad in 1868 outdid him in shrewdness and lack of scruple.[1]

The multiplication of stock and bond issues of railroad companies on the American stock exchanges gave these institutions a decidedly speculative character probably unequaled in any other important financial center. The essentially speculative nature of much of the railroad building and financing, resulting from the fact that railroads were being built ahead of the need for them to an unprecedented extent in this country, furnished the necessary background for the operations of such men as Gould and Drew. And the temper of the security-

[1] See Adams, Charles Francis, and Henry, A., *Chapter of Erie and Other Essays,* for an interesting account of this episode.

buying public in this market was such as to welcome the opportunity to assume the risks involved in the stock and junior bond issues, while European markets took mainly the senior bonds and the junior issues of only the better properties. European investors became holders of the more speculative American securities at this time principally only as a result of the recurrent waves of receiverships and reorganizations among the transportation companies.

The extent to which the speculative machinery expanded after 1875 may be traced in the following statistics of the volume of trading on the New York Stock Exchange:

Year	*Average Volume of Shares Sold Annually*
1875–1879	51,244,048
1880–1884	104,388,480
1885–1889	83,096,264
1890–1893	76,791,376

While the old large security distributing houses of the East, such as Jay Cooke & Company, Fisk & Hatch, etc., were eclipsed by the panic of 1873, a new group, also of a purely domestic character, made its appearance at this time. The price of capital in the West was naturally much higher than in the East, and there were many types of high-yielding western securities which, for one reason or another, could not be sold in Europe. Hence, a market for them had to be built up in our eastern cities. In the early 'eighties, several houses arose to sell western municipals and mortgages, and these houses gradually revived the methods of Jay Cooke, first developed in the sale of Civil War bonds. Thus N. W. Harris & Company of Chicago was at first ridiculed for efforts to sell bonds by the method of "ringing door-bells," as the widespread use of salesmen was termed. But it prospered nevertheless, and developed into a large wholesaling and distributing house under the name of Harris, Forbes & Company.

The end of this period witnessed the rise of the international banking houses to a position of complete domination in the financial organization. Numerous failures among the railroads brought about foreclosures which wiped out the equities of the original promoters and the later speculative managers, and they were replaced by the bankers who had sold the bond issues to investors here and abroad. These banking houses gained further prestige when the government had to resort to them in 1894 and 1895 for large loans in order to replenish its disappearing gold reserve, scattered by the disastrous experiment in large-scale silver coinage between 1890 and 1893. The prestige and wealth gained by the important banking houses at this time permitted them to play the leading rôle in the next stage of financial evolution, the consolidation of American industry into giant units.[1]

Trust and Consolidation Period (1893-1914)

The recovery of the country from the panic of 1893 was accomplished within a few years; and by 1896 a combination of bountiful harvests and industrial recovery had abruptly changed the financial position of the country, in the words of Noyes, from "the crippled industrial and financial state of 1894, with the country's principal industries declining, its great corporations drifting into bankruptcy and its Government forced to borrow on usurious terms from Europe to maintain the public credit," to that of "a community whose prosperity had become the wonder of the outside world, whose productive industries had developed such strength that the 'American invasion' was discussed abroad as threatening ruin to our European competitors."[2]

The accumulation of capital within the country ran for a time beyond the demand at home. One English estimate placed this annual capital accretion at $450,000,000.[3] Accordingly, a curious period of capital export developed, foreshadowing what was to happen on an immensely larger scale twenty years later. The international banking houses, whose chief function had been to furnish a link between the foreign capital markets and American corporations and governments, now

[1] Raymond, Wm. L., "History of American Investment Banking." *Barron's Financial Weekly,* May 31 and June 7, 1926.
[2] Noyes, A. D., *Forty Years of American Finance,* p. 257.
[3] Ford, Walter F., "American Investments in England," *Contemporary Review,* vol. lxxvx.

began to participate in English, German, Cuban, Japanese and Mexican financing to acquire securities for distribution in this market. In 1896 and 1897 alone, nearly $200,000,000 of foreign securities were offered in this market because of the plethora of capital seeking investment. At the same time, a large part of the American securities held in Europe flowed back to this market. By 1901, it has been estimated, about one-fourth of the American securities theretofore held in Europe had been repurchased and brought back here.

But this capital export movement was not destined to continue. It was merely a by-product of the rapid accumulation of capital at a time when public confidence in the domestic situation was still only partially reëstablished. Before long, huge drafts were being made on the domestic supplies of capital in rehabilitating the railroads. The Union Pacific, Reading, Northern Pacific and a number of others issued large amounts of securities and levied huge assessments on their stockholders in order to finance their rehabilitation. Within a short time, we find the European capital markets again being called upon to purchase issues of American securities because of the resumption of large-scale expansion here. Railroad development soon assumed an unprecedented scale because of numerous consolidations which resulted in the evolution of larger and sounder units in the industry. It was in this period that Hill and Harriman, the New York Central and the Pennsylvania, were engaged in purchasing control of most of the independent systems of the country in order to weld them into great communities of interest. The ability to sell 3½- and 4-per-cent bonds at par for the stronger properties stimulated these plans.

New issues of railway securities expanded as follows:

1898	$ 67,000,000
1899	107,000,000
1900	199,000,000
1901	434,000,000
1902	527,000,000

But the reorganization of the American railroad system was a relatively small task compared with the achievement which followed—consolidation of many individual plants in each of the important industries of the country into nationwide organizations. The protection of the tariff, the rapid growth of the home and foreign markets, the desire to avoid cutthroat competition and the avidity of the capital markets for new securities combined to favor this development; and between 1899 and 1901 there were formed 200 of our most important industrial combinations, such as the United States Steel Corporation, the American Can Company, the American Locomotive Company, the International Harvester Company, etc. Within this two-year period, new corporations with a total capital of $10,000,000,000 were formed, an achievement not again equaled for more than a quarter of a century. Most of this capitalization represented capital stock issued against goodwill or excess earning power—that is, it constituted "water." The public paid its money for this "water," thus transferring its accumulations of wealth to the previous owners of the different enterprises going into the combinations, and to the promoters and bankers who facilitated this transfer of ownership of large equities in our great industries to the public.

The investment banking mechanism expanded to a great extent to help in the absorption of these vast issues of securities. In order to attract public confidence, the great international banking houses and many of the older brokerage houses were given leading rôles in accomplishing such consolidations. This was a natural development, also, because large amounts of liquid capital were needed to accomplish these transactions; and, as was later revealed in the New York insurance investigation of 1906, funds of the life insurance companies themselves, which they controlled, had been utilized by the bankers in organizing the United States Steel Corporation, the International Mercantile Marine Corporation, etc.

As a natural corollary to the introduction of vast amounts of new industrial securities into the domestic capital market, there was an enormous expansion in the volume of securities turned over on the stock exchanges. Public speculation was rife, and the brokerage houses did a flourishing business. The securities of the new industrial combinations, although greatly watered, were eagerly bid up for a time by the outside public after they were listed on the stock exchanges. A worldwide rise in commodity prices stimulated both business activity and speculation—especially the latter—and the mass of the population was soon involved in the speculative vortex in one way or another, through dealing in securities or real estate.

The extensive capitalization of industrial enterprises and the sale of their securities to the public during these years made new types of securities available for investment and speculation here. Until this period, government and municipal bonds, railroad securities and bank and insurance stocks constituted the great bulk of the issues available. The only other staple investment was the individual real estate mortgage, for the largest portion of the national wealth still took the form of rural and urban real estate. After 1901, however, public utility and industrial securities gradually assumed a preponderant rôle in the securities markets. In 1898, there were only twenty industrial issues listed on the New York Stock Exchange, but by 1915, the number had grown to one hundred and seventy-three. In 1902, industrials and utilities accounted for only 25 per cent of the turnover on the exchange. By 1928, this figure had risen to over 94 per cent.

The industrial and financial expansion of this period naturally led to excesses, all the more so because of the sound basis upon which it originally began. The panic of 1907 and subsequent liquidation brought down values to a more normal level, and squeezed out a large part of the credit advanced by the banks for the purpose of carrying securities for a rise. Speculation for the rise in securities continued intermittently in the following years, largely because of the efforts of the expanded speculative machinery to keep going at a higher rate despite public apathy. The following record of capital issues and security trading on the New York Stock Exchange indicates the extent to which financial operations quieted down prior to the European war, as compared with the preceding period of reckless expansion and speculation:

Year	*Stock Exchange Stock Dealings (in shares)*	*Stock Exchange Bond Dealings (par value)*	*New Capital Issues*	*New Incorporations (000 omitted)*
1896	56,663,023	$ 394,329,000		
1899	175,073,855	336,451,120		
1900	138,312,266	578,359,230		
1901	265,577,354	999,404,920	*No data available*	*No data available*[1]
1902	188,321,181	891,305,150		
1903	100,748,366	684,200,850		
1904	186,429,384	1,036,810,569		
1905	263,040,993	1,018,090,420		
1906	283,707,955	676,392,500		
1907	195,445,321	527,166,350	$1,393,913	$2,545,053
1908	196,821,875	1,084,454,020	1,423,199	2,059,184
1909	214,425,978	1,314,656,200	1,681,621	2,465,073
1910	163,882,956	634,091,000	1,518,272	2,869,073
1911	126,515,906	889,567,100	1,739,488	2,906,002
1912	131,051,116	674,215,000	2,253,587	3,288,245
1913	83,083,585	501,155,920	1,645,736	2,191,659
1914	47,899,593	461,898,100	1,436,518	1,581,418

The regulation of investment banking came to the fore as a vital problem of the day after the public became directly interested in the security markets, especially as an aftermath of the panic of 1907. Many investors suffered heavy losses on account of both speculation and fraud, which had a sobering effect on the popular mind. Early regulation had concerned itself with incorporated financial institutions only and, as has been seen above, tended for the most part to the limitation of security holding and dealing powers of commercial and savings banks. Insurance companies were subjected to more rigid regulation after the Hughes investigation of 1906 had unearthed unsound practices. But the investment banker and the broker, carrying on their business for the most part as private individuals or in partnerships, were practically unregulated.

[1] A compilation of the authorized capitalization of industrial companies alone of $1,000,000 or more formed in this earlier period appears in an article by Charles A. Conant in the *Journal of the American Statistical Association* for 1901.

The figures are:

1896	$ 49,850,000
1897	81,000,000
1898	708,600,000
1899	2,243,995,000
1900	831,415,000

With the growing wealth of the country and the spread of security speculation appeared also a wider field of operations for the sellers of fraudulent securities. This hastened the popular demand for regulation of security selling, and led to the passage of the first blue-sky law in Kansas in 1911. The purpose of this Act was "to provide for the regulation and supervision of investment companies and providing penalties for the violation thereof." The Bank Commissioner was to receive data on all securities offered within the state, and also semi-annual statements of the condition of all investment companies doing business in the state. The operation of the law resulted in the revelation of a surprising condition. During the first year of its operation, out of 1500 applications for permission to sell securities filed, more than 75 per cent were adjudged fraudulent, about eleven per cent (162) highly speculative, and only about seven per cent (100) passed muster.

Kansas had a host of imitators. Within three years, twenty other states had passed similar laws; and the number was doubled after the constitutionality of the principle underlying these various acts was established. Efforts to pass a federal blue-sky law have failed, but a certain amount of protection is provided in interstate commerce through the anti-fraud section of the United States criminal code referring to attempts to use the mails for purposes of fraud. In New York, New Jersey and Maryland, blue-sky laws failed of passage; but instead, anti-fraud statutes were passed, which gave the state attorney special powers to prosecute after the fraud was committed. The subject of blue-sky laws receives fuller treatment in Chapter XXII below.

The War-time Period and After

The war-time period of American finance was characterized by an unparalleled expansion first of the industrial machinery and, secondly, of the financial mechanism of the nation, so that within ten years what had been vaguely predicted in 1897 became an actual fact, and the primacy in world finance definitely passed to this country. With the industrial consolidation movement largely completed before the war began, the basic industries were in a position to expand without difficulty as the need arose; and the financial strength and efficiency of many of the leading corporations permitted them a large degree of flexibility which stood them in good stead when Europe began to call upon this country to help supply war materials and supplies to her armies, as well as food and other materials available in reduced quantities because of the absence of millions of farmers and city workers at the front.

The consequent rise in prices caused a great increase in business profits and spread apparent phenomenal prosperity throughout the land, all the more because immigration was interrupted and labor was thus in a position to secure more than ordinary participation in the larger earnings available. With the large increase in the production of surplus wealth, we were able to absorb within a few years the great bulk of American securities which had been held abroad. In addition, several foreign loans were floated in this market, the most notable of them being the $500,000,000 Anglo-French 5½-per-cent loan of 1915, which the market absorbed fairly well.

With the entry of this country into the war in 1916, the situation was not essentially changed. The great demands from Europe were now met through direct advances by this government, instead of the resale of American securities owned abroad or the flotation of foreign bonds here. This government, in turn, raised by 1919 more than $20,000,000,000 in the domestic market through the sale of its own obligations, for the most part of long term. Although bank credit inflation was liberally applied as a lubricant in raising these vast amounts of capital, the actual disturbance in the money and capital markets was comparatively moderate.

Popular ownership of securities was vastly stimulated by war-time finance. One investment banker estimated that there were 200,000 holders of securities in this country before the war, and 20,000,000 afterward.[1] That the latter figure is not exaggerated is indicated by the fact that the $5,249,908,000 of Victory loan bonds were sold in 1919 to 11,803,895 individual subscribers. The Liberty loan campaigns, and customer and employee ownership plans as carried out by individual corporations, paved the way for the expanded efforts

[1] Warburg, Paul M., *Some Problems of the Investment Banker.*

of investment banking houses after the war to develop the security-buying habit in the American people.

The post-war organization of investment banking in this country has been outlined in the chapters preceding. To throw this organization into the historical perspective developed in this chapter, the following new essential features which have grown up in recent years deserve special stress.

1. The Increased Importance of Distribution in the Investment Banking Process.—Before the war, the investment banker in this country depended at least to a partial extent upon the foreign market to absorb new security issues. Furthermore, sales for the most part were made to institutional investors and a limited number of wealthy individuals and estates. Under these conditions, the banking house which originated a new issue constituted the most important cog in the machinery, since selling was a limited and simple problem.

With the vast increase in the number of investors, the problem of distribution has grown apace. At the same time, those houses which have developed extensive distribution power find no reason to depend further upon the big originating houses, so that the tendency has been altogether toward the combination of the origination and distribution functions within one investment house. At the same time, the problem of reducing the cost of distribution because of the smaller average size of individual sales has become urgent.

2. The Growth of the Investment Trust.—It is only since 1925 that the investment trust is more than an exotic experiment in this country. The investment trust here now constitutes the fastest-growing type of investing institution, and it has largely been amalgamated with the rest of the investment banking structure. The great bulk of investment trusts are now affiliated with or controlled by investment bankers who regard the investment trust as an extension of their other activities, using it as a means of increasing their operations in buying and selling securities with funds provided by investors.

3. Stocks Have Replaced Bonds as the Favored Investing Medium.—Two decades ago, a widely discussed question in the field of investments was the relative merits of real estate mortgages and corporation bonds as investments. Now the question arises between bonds and stocks, with the latter showing the greater popularity. When American industry was new and the individual enterprise was in its development stage, stock equities tended to be speculative and ill suited for long-term investment. With the relative stabilization of the industrial situation and the development of giant corporations abundantly supplied with fixed equipment and liquid resources, common stocks, constituting equities which share in the growth of earnings, have gained increasing favor. The difficult questions involved in comparing the merits of each of these two basic types of security are discussed at length in Chapter XIII. This increased popularity of stocks has also brought with it a great expansion of the stock brokerage business.

4. *The United States Has Become a Leading Creditor Nation.*—During the decade following the close of the war, some $15,000,000,000 of foreign securities were offered in this market. The greatly increased productive capacity of the country resulted in a surplus available for investment abroad, which was eagerly taken advantage of by foreign lenders during the post-war reconstruction period. Capital has flowed abroad not only through the sale of foreign issues here, but through large purchases by Americans of foreign internal securities, and through the purchase or development by American corporations of subsidiaries abroad.

5. *Methods of Corporate Financing Have Shown a Marked Change.*—As the individual enterprise has gained in financial strength, it has tended to rely less upon the commercial bank, and has built up instead large cash and security reserves through the reinvestment of earnings and the liberal issue of securities in the expanded capital market. As a result, the large business corporation has become both a heavy investor and, through making large collateral demand loans on securities, a commercial banker as well.

6. *A Growing Tendency Toward "Department Store" Banking.*—This has been shown through including both commercial and investment banking functions within one institution. The commercial banks, with the aid of more liberal legislation, have opened security departments and organized security subsidiaries, and have taken their place alongside the older type

of bond house as leading factors in the capital market. They have also gone rather generally into the trust business. Similarly, the brokerage house has in numerous instances entered the investment banking field, especially now that stocks have risen to a position of prime importance as investment media. Finally, commercial banks, investment houses and brokerage houses have all gone heavily into the business of organizing, operating and managing investing institutions through their investment trust affiliations.

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Part Two

The Theory of Investment Banking

Chapter VIII

THE THEORY OF INVESTMENT

Scope of Discussion

The second part of this book is devoted to the theory of investment. There are a number of general factors which exercise an important influence on the operations of the investment banking institutions considered in the preceding chapters. We shall study them before taking up investment banking practice as carried on by these institutions.

The theory of investment may be considered from the social or individual standpoint. The social point of view, which regards the flow of the annual income into investment, the influence of speculation upon the community, etc., is important in connection with the control of investment banking, as well as the forecasting of changes in investment conditions. For the individual investment banker and investor, a corresponding series of problems arises, involving the shaping of policies that best conform to these broad social changes.

As the more fundamental set of considerations, those which relate to the social theory of investment should receive first attention. Viewing investment as a process which goes on in every community, it may be asked exactly what this process consists of, and what limits or conditions it. By investment in the larger sense of the term is meant what is usually referred to by economists under the head of "saving," but including the further thought that the product of saving is to be applied to the creation of what are now called capital goods.

By capital in the economic sense is meant the forms of wealth whose service is found in the production of consumable goods, either directly or indirectly. They do not themselves yield any satisfactions, but they make it possible to obtain such satisfactions through the use of the product which they turn out. If A, for example, having a credit of $100,000 in the bank, devotes himself to the construction of a water power system, and thereafter sells the power or energy so developed, he has used his $100,000 in the creation of capital, and that capital yields a service—in this case, power—which can be sold and so reconverted into current funds. This process may be described as investment. The outcome of investment is the establishment of a flow of income resulting from the creation of the capital in question, and the use of it in such a way as to supply a continuous stream of economic goods or services.

It is thus clear that investment is a process of converting funds into capital, using the capital for the production of goods and services which are sold for funds that can be expended as may be desired. This last process of reconversion is the earning or receipt of income, such income being the flow of values which comes from the application of capital in the way indicated. It is clear that the process has no necessary connection with money, although the values employed are usually described in terms of money, so that we habitually speak of "investing money" or getting money out of investment.

We may next ask the question: When is a country better off and how is it better off, in an economic sense, as compared with some previous time? Evidently the measure of economic improvement is found in the increase, immediate or ultimate, of ability to command consumption goods, and this may come about as a result of new discovery, improvement in processes, or better organization of labor. It is quite possible that a change such as the better organization of labor might bring about a larger production of wealth from the same equipment and with the same number of persons at work. Ordinarily, however, this improved organization is rendered possible only through the use of machines, or the increase of fixed capital employed for the purpose of applying labor in a more efficient and satisfactory way. Better processes are usually dependent upon better and more effective employment of machines.

In short, the conditions which determine whether a country is or is not better off have to do with the volume of fixed capital which is employed in its processes of production, and the extent to which it can accordingly turn out goods without having to depend upon direct human labor. Investment in this sense, then, is the creation of new capital goods and their use in the strengthening and improvement of the processes of production. It has nothing to do with money or division of ownership, which is rendered possible by operations in stocks and bonds, but it is a process of rendering human economic activity more efficient.

Application of Wealth

Suppose that an individual is in possession of a sum of money or command over wealth of which he has become possessed as a result of his activities in various directions. He evidently has the choice of (1) "using" this money in consumption; (2) allowing it to lie idle, or (3) applying it to a purpose which does not involve immediate use on the part of the owner. This third means of employment of the fund is usually thought of and described as investment.

Investment, then, is the active application of current funds for some purpose other than the consumption needs of the owner. In current language, this is spoken of as investing or lending "money." It is an operation which involves, as a rule, the transfer of titles to money or bank credit, they being passed into the hands of others who agree to return them with a payment for their use which is known as "interest" or "profit." These others who obtain the use of such funds cannot pay interest or profit, however, unless they succeed in earning it. They must, therefore, use what they thus borrow not for consumption but for the purpose of producing more goods or services which are disposed of to others, and which consequently bring back a larger amount of goods or, in current phrase, "money," than what was parted with. If we eliminate these intermediaries, and look simply at the true operation, we shall see that it consists of applying current funds to the production of more wealth.

In a capitalistic society, this usually means the application of such funds to the manufacture or purchase of machinery or improvements of some kind—in other words, to the creation of what are called "capital goods" as distinct from "consumption goods." These goods are purchased or created because their owner will thus be able to pay the interest or profit which is demanded in return for the use of the "money" parted with by the person who had originally acquired or saved it.

The Flow of Capital Into Investment

In studying the flow of resources into investment, attention may first be given to the factors which influence the growth of new capital. These are the result of the process already designated as saving—that is to say, the direction of funds which have been created through labor or any other income-producing occupation, whether the rendering of service, the performance of business functions, or what not, into the purchase of production goods—goods which are not to be immediately used up or consumed. There is a steady flow of new capital which is thus coming into the market from savers, and which represents the economic surplus of the community over and above the amount expended or used for its current support. Thus A, the recipient of a salary of $5,000, may use $4,000 in paying his current expenses, so that at the end of the year he has $1,000 remaining as a bank deposit—current funds. He uses this surplus in buying part ownership in a business which he expects to yield him an income, or in developing some natural resource, such as a mine, or in building some piece of machinery which will facilitate the productive work of the business in which he is already engaged. In this way, investment takes place through additions to the existing total of funds which has been rendered available through the processes of labor and saving already described.

Of course these additions, made as the result of saving, are by no means "net." Perhaps the larger portion of such savings is needed for replacement of older capital goods, for capital of all kinds is wearing out from day to day. That part of capital which has taken the form of machinery, or physical assets, usually has only a comparatively short life. Other capital goods are being lost in any one of a number of ways: through fire, natural disasters, wars, etc. More frequent still are the cases in which losses of capital occur through badly conceived investment. Railroads may be built where there is an insufficient amount of business, and may later be abandoned on that account. Canals or roads may be constructed where natural conditions are unfavorable, so that the incomplete work has eventually to be abandoned. Perhaps the most important of all these factors is the very rapid process of industrial change in the modern world, which is constantly rendering capital goods obsolete. Industrial methods are changing. Given kinds of machines are being abandoned, and others substituted. Processes which were once economical have become less so, on account of changes in cost of material or the discovery of new methods. The result is the abandonment of machinery which may have practically no worth at all, or only a scrap or recovery value.

A balance sheet representing these items of gain or loss can theoretically be drawn up from period to period, not merely for the individual in terms of money, but also for the community in terms of capital goods. Such a balance sheet may be difficult to put into concrete form, but the data underlying it are present. Countries or communities are advancing or declining in their control over wealth. In order to ascertain their position at any given moment, some process of investment measurement is needed.

Measurement of Investment

It is often asked how the process of investment, viewed from the social standpoint, can actually be gauged. Various measures suggest themselves, the obvious one being simply to ascertain the difference between the annual production and the annual consumption of goods in a community. If the annual production may be taken as expressed by X number of dollars, and the annual consumption by a specified number Y, the margin of saving or investment is the difference between the two, or X minus Y. It is quite true that saving is not necessarily investment, but the margin of wealth available for saving may be thought of as offering the limit for such investment. All saved wealth may be invested; and if it is, then the difference between consumption and production measures both the savings margin and the investment volume. It is customary to measure the savings or investment margin in terms of dollars, a process which assumes that it is possible to ascertain the price of each unit of capital entering into the aggregate savings fund, and further that each such unit may theoretically be expected to command its price if sold. With these very broad assumptions, estimates of saving power or investment are, as stated, currently made in terms of dollars and have at least a comparative interest as relating to different periods of times. Such estimates must naturally take account of the replacement demand. One such estimate by Professor Willford I. King indicates the percentage saved between 1909 and 1917 as running from 12 to 27 per cent of the total national income.

Another method of estimating the size of the investment or savings margin is furnished by the selection of various indexes which are believed likely to throw light upon the scope of such a social surplus. The volume of new capital issues is one such index, which is discussed more fully in the next chapter. The volume of physical output of industry, especially that portion of it not resulting from a larger labor supply, is similarly indicative. Thus the National Industrial Conference Board has prepared the figure shown on page 197, which measures the extent of the increase in physical product of all industries since 1899 that is traceable to improved equipment and organization.

Factors of Supply and Demand

In the analysis of the investment process, it is desirable to consider, so far as practicable, the factors entering into demand for, and supply of, investment funds. This furnishes a means by which to gauge the tendencies at work at any given time to change the character or extent of the flow of funds into the investment market.

Looking at the subject of the demand for investment funds analytically, we are able to recognize four or five distinct factors which determine its intensity. Important among them is the rate of economic development in the country, including such questions as the state of its industrial arts, the degree of fluidity or permanence which has been attained by its economic

PRODUCT OF MANUFACTURES

UNITED STATES, 1899-1925

ALL INDUSTRIES-PHYSICAL PRODUCT

Relative to 1899

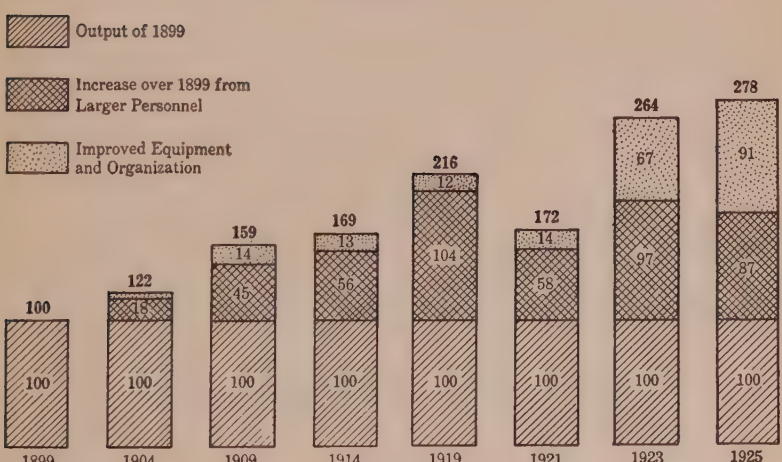

FIG. 7.

organization, the relations between capital and labor, and a variety of other factors. Of importance also are the character of its financial market, the degree of initiative that is shown by its promoters and investment bankers in their search for new opportunities, and, generally, the degree of success attained in bringing about a prompt response on the part of active business men to the opening up of new opportunities through invention, through change in international relationships, or otherwise. Finally, a place of some importance must be assigned to the position in the business cycle that has been reached at any given moment by the economic organization of the country. The activity of demand for investment resources, other things equal, will be greater or less as the business cycle may be regarded as passing through one or the other of its various phases, as set forth in Chapter XIV. The demand for capital in the United States is discussed in the following chapter.

On the other hand, analysis of the supply of capital may be made in the same way. Such analysis emphasizes the stage of economic development as a determining factor just as does demand, since in some of the various stages of national economic growth there is a much larger fund of savings forthcoming than at other times. National habits in connection with the use of wealth and savings—the extent to which profits and earnings are employed as a basis for luxurious outlay or are used for further production—have an important bearing. The extent of the distribution of wealth among various classes, and the influence thereby exerted upon the volume of savings, as well as the character of the opportunities afforded to savings by the investment banking organization of the country, also have an important share in determining the amount of the supply of funds going into investment.

The factors of supply of and demand for capital which are thus referred to are obviously large, and raise a variety of important theoretical questions. We may ask in any given case, in what circumstances do investments increase most rapidly? Is investment assisted by industrialization? Does a given kind of distribution of wealth facilitate its growth? Is it aided or retarded by specified forms of economic organization, such, for instance, as coöperation? All these questions must be dealt with in some way before final conclusions with respect to the growth of social capital can be drawn. They open a large field of discussion and can be only raised here, without any effort to furnish a solution even of the major issues involved. The point that is worthy of noting for the purpose of our discussion is that the total fund of wealth entering into investment is not only extremely complex, but sensitive, and varies over short periods of time in such a way as to produce great differences in the total volume of wealth available for investment. Large underlying factors of this kind condition and determine the circumstances under which individuals apply their resources in the purchase of securities.

Capital and Economic Development

A somewhat closer view of the major factors already suggested as influencing supply and demand will be worth while. Attention may first be given to the stage reached by a country in its economic development. As is generally known, the study of economic history shows various well-marked phases through which practically every country passes in the process of combining labor with its natural resources. In the United States, for example, we first passed through a period in which the main problem was that of establishing communication and transportation and bringing the whole country under general control. This was succeeded by a more intensive period of capital application and development, during which natural resources were being exploited, and industrial centers located at strategic points. This, in turn, has been followed by a period of corporate and financial reorganization, in which effort has been made to increase the division of labor and to establish more effective working relationships between the different elements necessary to industry.

The supply of actual funds growing out of the economic activities of the country, and particularly that portion of the supply which may be regarded as a "surplus," in the sense that it is available for transfer or direction into this, that or the other field, varies widely, and tends to become more abundant as a country reaches the full measure of its control of natural resources combined with effective machinery for developing and marketing them. Each enterprise then tends to accumulate a large surplus of its own, to pay large dividends to stockholders and to have little need for new capital, as the openings for new investment become more limited.

The demand for capital, at least for domestic investment, reaches a peak when industrial growth attains its full measure of development, and tends to decline thereafter. Many of the European countries, such as England or Holland, have reached this latter stage. They are making fairly full use of their natural resources, as far as present-day technique allows, and they cannot expect to open up many new enterprises within their home territory which may be capitalized and represented by security issues. In the United States, on the other hand, industry is still in a dynamic condition, and there is large opportunity for the application of additional funds in the opening up of new branches of business, and hence a large field for exploitation through securities issued. The demand for capital here is still tending to rise, though at a much slower pace than formerly.

In a country which is practically fully exploited and in which industry is amply equipped, the need for new investment funds is likely to be small; and even if savings are large, it is difficult to find an outlet at home for them. It is for this reason that many countries are habitual exporters of capital, and that in a good many cases they have found it necessary to seek outlets in so-called "colonies." In such countries, the volume of saving is greater than the opportunity for investment, with the result that funds must be placed elsewhere. In the converse case, in which a country has reached a phase of active economic exploitation, and has large opportunities opened to it wherein new capital can be employed to advantage in increasing production, every effort will be made to attract savings; and when their supply is insufficient at home, the attempt will be made to draw them from abroad by the offer of high rates of return, freedom from taxation, or superior advantages of one sort or another.

Extent of Risk

The supply of investment resources is always largely affected by the amount of risk which is involved in their use. In looking at this factor in the supply of capital, just as in studying the influence of different stages of development, valuable illustration may be obtained from the experience of different countries. In some, where rich natural opportunities have presented themselves, exploitation appears to be accompanied by small hazard of loss. Almost anyone with funds can find a safe opportunity for their employment, with a reasonable probability of at least moderate returns. Into such countries, capital naturally flows freely from outside sources, while the rate of saving on the part of inhabitants tends to reach a high point.

Most sections of the United States furnish satisfactory examples of the development of capital flow through limitation of risk. On the other hand, in new countries, such as some of the South American states, where political uncertainties often arise, where natural resources, although abundant, are hard to reach, or where distance makes marketing expensive, the risk of investment is fairly high. In the Philippines, for example, it is usually stated that, while profitable openings can be found for those with large capital who can afford to take risks and lose money for a time, it is difficult for the small man to find a safe opportunity for the use of limited quantities of funds. Accordingly, rates of interest necessarily have to be high, and it is customary there to say that the risk element is large and that otherwise the cost necessary to induce capitalists to furnish funds for investment would be lower. Where risk is limited, the return on investments is lower, and the result is a steady, reliable flow of funds into investment channels at reasonable cost.

National Habits and Wealth Distribution

How national habits affect the supply of capital may be understood from a comparison of such a country as Russia, as organized under the old form of government, with such a country as Holland or England. In Russia, the ownership of wealth was largely in the hands of a small group who preferred to spend most of their time abroad, and who drew heavily upon the revenues of their estates in order to meet their extensive liabilities incurred through luxurious living. As a result, capital was always scarce in Russia, and the country was under-developed, possessing little machinery and only a poorly organized system for the exploitation of its very valuable and extensive natural resources.

Holland, on the other hand, much smaller in area, and with a much less satisfactory supply of natural resources, was occupied by a thrifty population. The inhabitants were disposed to make the most of the opportunities open to them, and did so; with the result that the margin of savings, always substantial, was employed to the best advantage, thereby greatly enlarging the available supply of capital and rendering it possible for business to equip itself with practically any facilities it might require for the more effective prosecution of its efforts.

Similar though less well-marked distinctions between the practices and ideas of different communities may be found within various countries, and may be noted for example in the United States. Some sections of the country, like New England, are given to thrifty use of incomes, with constant reinvestment and an abundant supply of capital; while other regions are far less well equipped, less disposed to save, and consequently find it necessary to draw their capital from other sections of the country by borrowing. In the former regions, the rate of interest tends to be comparatively low, while in the latter a high level of charges is the rule.

The influence of the distribution of wealth upon the investment situation should be given a foremost place in any study of the social theory of investment. Which condition of affairs best promotes the growth of capital: a situation in which wealth is very widely divided among the different members of the population, or a condition of affairs in which wealth is highly centralized? As we have seen, it is the total savings margin, or difference between production and consumption, which determines from year to year how much can be saved, and accordingly how much will be. But within this margin, the determination of the actual amount going to savings is a matter which must depend fundamentally upon the determination of members of the community who have this margin within their control. It is they and they only who can furnish the ultimate decision as to whether income will be saved or not, and also (in individual investment) what form will be given to the saving through its distribution among investment demands.

The question which is thus raised with reference to the effect of the distribution of wealth upon investment can be generally answered without much difficulty; the effect of distribution depends upon the relative inclination of the various classes in the community with regard to the use of their funds. In a society in which living standards are simple and mere extravagance is not admired for its own sake, it is undoubtedly true that a high concentration of wealth favors a high rate of saving. Conversely, a situation in which wealth is widely divided among a frugal population greatly devoted to saving also tends to maximize the amount of investment from the social standpoint.

Investment Banking Mechanism

Along with these broader factors which tend to control the supply of capital available, it is desirable to consider also the character of the investment mechanism that can be used by the community. Thus, for instance, the existence of satisfactory arrangements for banking and security distribution invariably tends to stimulate the growth of savings. Much has been said about the question of farm credit in the United States within recent years, and the discussion has brought out the fact that mortgage banking has stimulated the flow of funds into rural investment. Postal savings systems have been found in many of the older countries to be great stimulators of savings, and the same thing is true of the so-called popular banks, or people's banks, which are numerous in some European countries. In the United States, mutual savings banks and building and loan associations have collected over $16,000,000,000 that would probably never have been accumulated if these organizations had not existed. The presence of stock exchanges tends to create an interest in securities, and a more receptive attitude on the part of the community at large with respect to the investment of funds in enterprises which involve some risk. The satisfactory organization of banking largely influences the ability of business men to obtain the funds needed for the development of their operations. Thus it may be fairly said that both the supply and use of capital are greatly affected by the character of the machinery which is available for saving, distributing and using it, and that two countries of equal resources and natural strength will vary widely in the volume and cost of their capital, according to whether they make use of better or less satisfactorily adapted investment machinery.

In fact, modern industrial society has at least made a beginning in the development of what may be called an automatic saving mechanism. The modern corporation has it in its power to limit the distribution of its earnings among stockholders. It must determine what proportion of its earnings is to be paid to the owner, and what proportion is to go back into the business. Most large corporations reinvest a substantial part of their earnings, which are devoted to the extension of the capital plant of the undertaking. This, it would seem, is a function which, taken in the aggregate, has a large effect in determining the immediate use of the current earnings of business enterprises, and may operate to enlarge, and sometimes to over-specialize, the plant equipment of the country. Perhaps the greater part of our annual savings is made in this way.

Somewhat the same may be said of the influence of institutional investment, such as that carried on by the insurance companies. Such investors have been intrusted by the community with a part of its current income for a specific purpose. It is within the power of such an institutional investor to decide how its funds shall be used. Thus, in studying the investment margin of any country, attention is properly given to the relative degree of development that has been attained by corporate and individual investors of the types above mentioned.

The demand for capital is greatest in countries where active corporate promotion is going on. At times, the optimistic business men and financiers who have held rather too hopeful a view of the possibilities may be too encouraging in their representations to prospective investors. Ordinarily, the investor is not particularly well qualified to judge of the true worth of securities. He has to depend more or less upon advisers in the financial field who enjoy his confidence; and when these have quite generally fallen under the influence of a speculative fever, their opinions are not to be fully trusted. During such a fever, active promotional work usually results in floating considerable quantities of securities which are either ahead of their time, representing investments that may become valuable at a later date, or are perhaps largely or wholly bad, representing misjudgment or occasional dishonesty, or, at best, over-valued. In any such case, it is the activity of the promoter and the speculative investment banker which many times has been responsible for enlarging the commitments of the community and bringing about a large output of securities offerings which constitute a demand for the capital funds of the community. Sometimes a situation of this kind has results which are serious and long lasting. For example, the commercial disturbance or panic of 1873 has often been ascribed to excessive absorption of capital and savings in the construction of the trans-continental and other railroads which had been built just after the close of the Civil War for the purpose of linking the different parts of the United States more closely. There was undoubtedly good reason for this investment, but there was not enough business, either present or immediately prospective, to warrant investors making so large an outlay, if they expected to get any adequate return in the way of income. But while American corporate promotion has been quite venturesome, often leading to substantial losses, it has on the whole been remarkably successful, and has greatly helped in placing this country in the forefront among industrial nations.

Relation to the Business Cycle

The stage which has been reached in the business cycle in any country materially influences the volume of income and savings which are available for investment, as well as the demand for investment funds that makes itself felt. When business (and perhaps prices) are advancing, and when the whole economic mechanism is active, the natural tendency is to see profit possibilities in many directions which have formerly been viewed with some degree of pessimism. Promoters are anxious to develop given branches of business and to sell securities for that purpose. Investment bankers see the opportunity to place offerings which they believe will appeal to the popular fancy of the moment, or which are the outgrowth of new *bona fide* industrial undertakings which are just appearing. The result is that during the upward movement of the business cycle, there is invariably a strong tendency for the demand for capital to increase, which may at times result in the offering of higher rates of interest or more attractive participation in earnings to investors.

At the points of "peak" or of depression, there is comparative quiet in investment demand. The downward movement is accompanied by a falling off of new offerings, and by an indisposition on the part of the public to buy them. This is partly the result of changes in the attitude of mind or psychology of the community as regards the whole subject, but it may also be due to actual changes in the need for funds. It frequently happens that during the upswing of business many industries are over-provided with capital—so much so that they have surplus funds which they at times relend. During the downward movement, they of course are not in the market for new capital. The relation of the business cycle to the field of investment is discussed more fully in Chapter XIV.

Cost or Price of Capital

This analysis of the factors of demand and supply of capital naturally raises the question of how an adjustment is brought about between them. As in most economic relationships, this adjustment is effected through a process of changing the current price or remuneration which is paid for the use of investment funds. That price is what we ordinarily call the rate of interest.

Income on investment is a payment to the owner of the funds for their use. It must be sufficient in amount to induce him to prefer the application of these resources to investment rather than to immediate purchase of commodities. If an absolutely safe investment could be conceived, the interest on that investment would be merely the minimum amount necessary to induce owners of funds to save and part with them. No such investment, however, can be found; and accordingly income on investments must be regarded as consisting of at least two elements—interest on capital, and payment for risk or hazard in connection with the repayment of the funds at their full face value. In addition to these two elements, a third is usually to be recognized—a payment for management to cover the time and expense involved in dealing with the funds, transferring them, rendering them available, keeping them idle for the average time between investment changes, and the like. Other additional payments may be included in the rate of income required to induce an individual owner of funds to make a given investment, but these are undoubtedly the chief. Expectations of special future benefits, such as special disbursements, will cause current yields on stocks in many cases to fall far below this figure.

Like other economic payments which are made to harmonize demand and supply, interest rates move higher when demand is strong or supply small, and lower when supply is large and demand inadequate to absorb it. The factors of demand and supply have been analyzed in the foregoing paragraphs, and no recapitulation is necessary at this point. It is enough to say that in the capital market demand and supply are quite closely and delicately balanced, so that the rate of interest commonly affords a very reliable barometer of changes in the capital situation. It must of course be remembered, as is explained in Chapter X on the money market, that the capital market is divisible into several sections corresponding to different purposes, so that there is seldom or never perfect competition between lenders and borrowers in all parts of it.

Over- and Under-saving

In the process of investment there is always an open question as to the capacity of a given market to "absorb" the investment surplus of the community. It does not follow, merely because an individual or a group are of saving habits and can put aside a proportion of their income from year to year, that there is always a satisfactory way in which to apply these savings so as to bring the owner thereof a regular income. The older economists were of the opinion that in almost all countries gradual expansion of population, and what they called the pressure of population upon subsistence, would eventually bring a community to a "marginal point" at which it was doubtful whether the further investment of savings would produce a large enough additional income to be worth while. Examples of this kind have been furnished by some of the older European countries, in which practically all natural resources have been brought close to the point of marginal productivity. In other countries which are very far from having reached any such point, however, as in the United States, there is always a question as to whether a given field of business may not have been developed about as far as there is any occasion for it. For example, it may well be questioned at any given moment whether any further investment of funds in factories devoted to the manufacture of farm machinery will bring a return on the amount so spent. If capital is put into fields which are thus close to the margin of productiveness, it may be expected that the returns will be small so that the investor will be correspondingly disappointed.

The converse of this situation also holds good. Industries may easily pay too high a price for the funds they seek. If they offer securities on the market under certain conditions, they may find that there is no demand. Either the savings fund of the community has already been absorbed, or all that part of it which can be expected to be available at the rate of interest on the new securities has been exhausted. There is probably seldom a time when higher rates of interest will not call forth new savings funds in some quantity; but the question is whether or not the users can afford to pay more in order to bring about the offer of such funds. It is the function of the capital market to bring about an adjustment between demand and supply, at a price which will equalize the two sides of the dealings, without regard to such questions.

It is thus a frequent occurrence that the investment market machinery already described fails to function perfectly. Due to a variety of causes, it may easily happen that there will be an excess of investment securities brought into the market and offered for sale, with the result that the volume of current saving is not able to absorb them. In the same way, it may be that large savings occur, with the consequent placing upon the market of an undue volume of such savings offered as purchasing power for securities. When either of these conditions takes place, there is a lack of adjustment or balance between supply and demand, with a consequent tendency to raise the values of securities above reasonable quotations or to depress them below such a level, according as the supply of securities, as compared with savings funds, is scanty or overabundant. These variations result in corresponding variations in the yield to be derived from the securities which are thus purchased by investors. Advances in such income or a tendency to decline below the normal level tend in turn to stimulate or retard the rate at which savings are made, and thus again a condition of balance may finally be brought about.

It will be noted that frequent reference has been made to the so-called normal adjustment. As in all economic writing, it is desirable not to use this word without assigning to it a definite meaning, and that meaning is for our purposes the level at which demand and supply are in balance, producing a rate of interest just sufficient to bring forward continuous additional supplies of savings adequate to meet the demand originating with those who are willing to pay a reasonable rate of return. When savings are available in excess amount or when money is unduly easy, the result is to enable some users of capital to get it more cheaply than they should. This condition of things tends to bring about an excess production of the goods that are being turned out by the industries which are thus enabled to obtain funds for capital use at unduly low rates. In a similar way, whenever some industry or industries are able to obtain the use of funds for working capital purposes only by paying rates that are unduly high, the effect is to restrict the total amount of output which should come from such enterprises. Unduly cheap or over-costly capital has the effect of throwing out of gear the industrial mechanism which is linked up with the investment market.

Over-saving or under-saving, over-borrowing or under-consumption of capital, all react upon the industrial output, affect prices in one way or another, thus influence the net earnings of the enterprises which are responsible for the change in production and distribution, and thus eventually work back into the investment field by affecting the quoted value of the securities of the enterprises which have been dependent upon unduly costly or unusually cheap supplies of capital. Thus the circle of saving-investment-industrial development-prices-earnings-securities value is completed. The aid given in the performance of this function by the stock exchanges and by other securities markets is perhaps the most fundamental justification of their existence—the best illustration of the service which they render to the economic organization of society. The question of investment credit control is discussed more fully in Chapter XII.

Relations with Foreign Markets

It often happens, of course, that the processes which are here described are proceeding at a different rate in different markets. Accordingly different levels of prices for similar securities exist in the two markets. Take, for example, the case of government securities in a country which is unquestionably sound and stable but relatively short of capital, and the same class of securities in another country similarly stable in its position but with much better assurance of the capital it needs. In the second country, investors will be willing to pay more and to accept a lower rate on the public issues than they will in the first. A similar parallelism with lack of exact identity may be traced in almost any class of securities as between two given markets at the same time. The "lag" in one as compared with another is the result of many causes of friction or retardation which differ in differing instances. When the existence of such a situation is perceived, investors in one country are likely to try to transfer their funds to another by purchasing securities of the country whose markets afford the best returns.

Thus at the present time not a few investment trusts definitely pursue the policy of selling securities in markets where interest yields are low and quotations correspondingly high, while buying them in other markets where interest is high and capital values comparatively low. There is always enough friction and lack of competition between different countries due to differences in banking systems, laws and political conditions to cause considerable variation, but the process of transfer already described steadily operates to cut these discrepancies to a minimum and is usually successful in bringing that state of things about.

Bank Credit *vs.* Capital

Because of the fact that both capital and current funds are usually stated in terms of money, a great deal of confusion is often noted between them, loans being spoken of as differing merely in the time for which they have to run. As a matter of fact, the difference between the two is much more fundamental; and it must not be forgotten in the study of investment that deposits in, and funds disposed of by, the bank represent merely the surplus of the community's funds which is available in more or less liquid form, and can be directed to any one of several different channels. Any unit of it may be employed for consumption or devoted to investment, according to the decision of its owner.

The rate which is charged for bank funds, or the rate of interest for money, is ordinarily more sensitive and more easily changed than is the rate on long-term investments, such as bonds. Both, of course, go back to the same general determining factors of supply and demand. The same elements which tend to make the charge for money high will in the long run exert the same effect upon capital funds, and *vice versa.* However, there frequently are periods of divergent fluctuation, in which the two groups of rates move separately from one another, perhaps, in fact, in opposite directions. Possibly the most influential factor tending to bring about this kind of divergence between the two classes of rates is speculation. Speculation ordinarily requires as a basis substantial advances of current funds, and these will normally be obtained from the banks. It is thus an added element of demand for the current resources of the community, and its influence is to raise or accentuate rates of interest for money. This may occur at the time when rates of return upon long-term capital are actually falling or are nearly stable. Good illustrations of these tendencies are found in the movements of long- and short-term funds at various periods during the years 1926-1929, especially in the New York market.

Control Over Capital Flow

From what has been said, it will be apparent that capital movements, like other economic shifts and changes, are likely to go at times too far in one direction before an opposing movement sets in and furnishes the corrective to a change that is possibly being overdone. It is never desirable for a community to pass from one extreme to another, as it is likely to do where competition is unrestricted. Accordingly, the effort of the financial community has always been that of bringing about some kind of control or regulation of capital movements which may operate more or less effectively to prevent unwise extremes from occurring. Several such types of efforts at control may be recognized. One is that of direct regulation, such as legislation, or indirect regulation through the banking structure and the money market, as considered in Chapter XII.

A second method of control is through the application of the insurance principle. In a later chapter some examples of the application of this principle will be reviewed; but at this point it is worth noting that, from the purely theoretical standpoint, the function of insurance is not merely that of protecting the individual against loss, but also of equalizing the losses through erroneous investments and spreading them out over the entire field of capital use. As different lines of business reveal through experience greater or smaller hazards, the application of the insurance principle to them becomes possible.

Careful analysis of the credit risk of individual enterprises similarly results in regulating the investing process. The setting up of standards of wise or safe investment operates to restrain those who might otherwise be induced to apply capital funds in unpromising directions, and who might thus divert resources which are needed by essential industries to lines of business in which the outlook is not promising or is merely specious. This process of analysis is necessarily an expert one, hence the necessity of intrusting it more and more to those who are technically familiar with business possibilities. Investment credit analysis in its broader aspect is taken up in Chapter XVI.

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Chapter IX

THE DEMAND FOR CAPITAL

The Flow of Capital

The investment surplus described in the preceding chapter does not flow as one steady and unchanging stream through the various channels of saving into the several classes of investment. It may rather be likened to a mountain torrent, which is constantly shifting its course to new channels in response to changing conditions. Hence any description of the capital market, understanding by that broad term the several classes of buyers and sellers of securities discussed in Part I, must be based on a fundamental understanding that the market is in a continuous state of flux.

The net annual addition to the capital of the country may be defined as the increase in income-producing assets, tangible and intangible, which takes place during each year. This addition to the capital of the community is made out of the surplus income, or savings, of individuals and corporations.

The savings of individuals are invested in part directly in buildings, real estate mortgages bought direct from the borrower, and other forms of wealth not requiring the intervention of the investment banking mechanism. Therefore, only a portion of individual income is free for investment in securities, and thus constitutes a demand for new security issues. When the individual investor has a surplus of funds available for investment, it does not matter, from the viewpoint of the market as a whole, whether he buys a new security or one already outstanding. Should he purchase an outstanding bond or stock through his broker on the stock exchange, he turns over his free capital to the seller of that security, who will then be in a position to buy a newly issued security. Capital is thus made available for the purchase of new securities, regardless of whether the investor buys new or already outstanding securities with his savings.

The surplus earnings of a corporation, in so far as they are not distributed to shareholders as dividends, thus constituting individual income, are retained by it for use in its own business. This direct reinvestment of surplus income is an automatic savings process beyond the pale of investment banking, and a very large proportion of the annual savings of the community is made in this way. It is reflected in a steady rise in the quoted market value of the shares issued by these corporations.

The stream of free investment capital which thus originates in the main as surplus earnings of individuals divides itself into many sub-streams and rivulets. One major division is the separation of a large fraction of the total for export abroad. The remainder, invested at home, goes into the various types of domestic enterprises, being diverted from one field to another from time to time according to the returns offered and the prevailing sentiment of the investing public. Finally, there is a frequent shift in the form of financing between stocks and bonds according to the state of the capital market.

Interpretation of New Security Issue Statistics

The statistics of new security issues, as presented and analyzed in this chapter, must not be accepted blindly as measuring the extent to which capital is being invested in different ways at any one time. The data are useful only after their limitations are understood.

In the first place, a large part of the new security offerings represents refunding new issues put out to replace others previously outstanding. Such refunding operations may be for the purpose of paying off a maturing obligation, or reducing the rate of interest on outstanding bonds by selling a new issue with a lower rate of interest. The proportion of new financing consisting of refunding is greatest in periods of rising bond prices, when many corporations rush to refund their high coupon bonds with issues of low yields. It is also large in the earlier periods of a boom in stock prices, when many corporations call in bond and preferred stock issues and replace them with common stock, thus strengthening their capital structure and reducing fixed charges. The percentage of new financing representing refunding between 1923 and 1928 was as follows:[1]

Year	*Refunding Issues*	*Percentages of Total New Financing*
1923	685,319,706	14
1924	759,300,015	12
1925	905,854,350	13
1926	1,086,140,755	15
1927	2,135,574,365	22
1928	1,877,421,537	19

In addition to refunding, a large proportion of new financing represents the sale of securities of established but privately owned businesses to the public. In this case, no new capital goes into the enterprise whose securities are offered by the investment banker, but the securities formerly closely held are issued for public subscription. Thus, in 1924 Dodge Brothers, Inc., after having been closely held by the Dodge family since its inception, was sold to bankers for $146,000,000 in cash, and the bankers then sold securities largely in excess of this amount to the public. Did the issues of Dodge securities represent new capital?

The answer is that no new capital went into the Dodge enterprise itself. The financing merely represented a transfer of ownership, the funds of investors being turned over to the Dodge owners for the purchase price, and the balance going to the bankers as profit. If the recipients of the investors' money invested it directly in some other productive enterprise, the Dodge issue would represent the raising of new capital going into industry. More usually, however, capital raised through the sale of a closely held corporation to the public is put into already outstanding securities, so that the free capital is transferred on to other holders in the market. If this capital, after passing from hand to hand through the purchase and sale of

[1] "Summary of New Financing," from *The Commercial and Financial Chronicle*, vol. cxxviii, p. 316.

already outstanding securities, is finally invested in a productive enterprise by some individual who sells his securities to invest the proceeds in his own business, then the capital originally invested in Dodge securities represents an addition to the total accumulation of capital in the community. On the other hand, should the money be invested eventually in a new security issue, then the same amount of capital has been counted twice in the new total of new security offerings—once when it was placed in the securities of an established business being sold to the public, and a second time when the proceeds, having passed from hand to hand in the securities markets, are finally invested in some other new security issue. There is duplication resulting from issues of securities previously privately held, therefore, in addition to the element of refunding, that must be borne in mind in interpreting statistics of new security flotations. Flotations of investment trusts and other organizations formed for the purpose of buying already outstanding securities similarly may not reflect in themselves a net accretion to the aggregate net savings of the community.

Finally, it must be remembered that a substantial portion of new security issues is not distributed to investors immediately, but is carried on credit. In the case of new stock issues, a large part may be carried indefinitely in margin accounts by brokers, so that the amount of the issue does not represent savings received from investors, but only partly that and partly credit absorbed from the banking system. The relation of the money and capital markets is discussed in the following chapter.

These various factors make the statistics of new financing only partially representative of the process of investment as it is constantly going on in an economically advanced country. In so far as refunding issues, sales of closely held stocks to the public, and investment trust issues are concerned, statistics of new capital flotations overstate the volume of savings. Since direct investments made without public offering, the reinvestment of corporate savings, and investments in individual realty mortgages, etc., are generally omitted, the volume of savings is understated by such statistics. However, they are the best figures available for measuring the current volume of savings, and if used as approximations they throw considerable light on variations in the direction of the flow of investment resources into various channels and on indicated changes in the aggregate investment fund from year to year.

Classes of Domestic Issues

Until the beginning of this century, the railroads absorbed the largest portion of the new capital which flowed through the investment market. During the period of industrial consolidation which followed, basic manufacturing industries, like steel, forged to the front as the largest issuers of new securities. In recent years, with the enormous advance in electrical technology, the public utilities have taken a leading place.

The following table shows the amount of new domestic financing for each year in the five-year period 1924-1928, and the percentage absorbed by the railroads, public utilities, industrials, real estate operations and municipalities:

Year	Total financing[a]	Percentages of total					
		Railroad	Public utility	Industrial	Real estate	Farm loan	Municipal
1924......	$5,416,630,222	17.4	28.2	19.1	6.2	3.3	25.8
1925......	6,325,972,683	8.1	27.3	27.6	11.9	2.9	22.2
1926......	6,795,936,184	6.2	29.0	31.9	10.8	2.0	20.1
1927......	8,993,493,005	10.7	33.2	29.9	7.4	1.9	16.9
1928......	9,232,402,520	7.9	28.6	38.8	8.7	0.7	15.3

[a] Except foreign government issues.

The above figures reflect the fundamental changes that have taken place in the relative position of different industries in the investment markets. The railroads, under conditions of rigid government regulation and suffering from the competition of other forms of transportation, are loath to borrow money which they are not certain they can use profitably.

The carriers have found that there is strong resistance to any substantial increase to their earning power; hence to add to their capital liabilities through the sale of additional bonds and stocks is not usually attempted except where there is virtual certainty that earnings will be large enough to cover the capital requirements on the new securities by an adequate margin.

There is no reason to believe that railroad financing in this country will ever recover a dominant position. The railroad net of the country as at present laid down gives adequate facilities to most of the well-populated areas. For local traffic, the automobile and motor truck are in many instances replacing existing branch lines of railroad, and there is certainly no basis for much future building of short lines. Hence, financing for new construction will be small. With business men and farmers agitating steadily for lower rates also, improvements to existing lines must be made in moderation if capitalization is not to outrun earning power.

Railroad financing is strongly influenced by the fact that their seasoned character gives to railroad bonds a preferred position in the laws governing legality for institutional investment of savings banks, insurance companies and trustees—a position which their present relative prosperity alone would hardly justify. As a matter of fact, more than one-third of all outstanding railroad bonds are held by financial institutions, and 70 per cent of the increase in railroad bonds outstanding from 1921 to 1926 went to the insurance companies. The situation is shown in the following table, summarizing holdings for 1926:

Institution	*Railroad Security Holdings*
Life insurance companies	$2,517,789,000
Mutual savings banks	646,836,000
National banks	631,387,000
Fire and other insurance companies	341,000,000
Loan and trust companies	277,521,000
State and other banks	70,436,000
Total	$4,484,969,000

The public utilities, enjoying a steady increase in business and liberal regulation at the hand of state commissions under the protection of Supreme Court valuation decisions, have absorbed large and increasing amounts of capital which investors, impressed by their record, have been willing to give them. Among the public utilities, the electric light and power industry, with its $10,000,000,000 investment, is the largest factor. Owing to the growing use of electric power in industry, in the household and on the farm, this industry has been able to show production increasing at the rate of nearly 10 per cent annually. This larger output, along with steady improvements in methods, has permitted the industry to do just what the railroads cannot do—cut rates at the same time that net income steadily increases.

The electric utilities have been responsible for much of the refunding which has been carried on during the last few years, as their improved credit has permitted them to replace by lower coupon issues the high-yield bonds sold during and shortly after the war period. Thus, in 1928, the electric power and light companies alone raised nearly $1,500,000,000 of new capital, but issued also about $350,000,000 of securities for refunding. Now this refunding is largely a temporary matter, so that the total volume of public utility financing may show in the future a moderate reduction as compared with the 1927 and 1928 records, although the volume of new capital flowing into the industry may be as large as ever, or larger. Another factor which tends to facilitate the raising of capital by the electric utilities is the tendency of state laws to give them a larger place among securities legal for institutional investment. In 1928, a selected list of these bonds was made legal for the first time for savings bank investment in New York State.

The communications industries represent an investment of some $4,000,000,000, of which the bulk is in telephones. This industry and the gas industry, whose investment is above $2,000,000,000, are enjoying steady growth, although at a rather slower rate than in the case of the electric utilities. The water and street railway utilities are absorbing much less new capital, although the former has shown increased activity of late in connection with merger developments. A special compilation of public utility financing for 1928 showed the following:

Electric light and power	$1,878,034,925
Telephone	263,603,550
Gas	200,060,670
Water	87,720,625
Street railway	15,000,000
Total	$2,444,419,770

In summary, therefore, it would appear that, except for some reduction on account of the elimination of refunding, the public utilities will retain the foremost place among American industries in absorbing new capital through the securities market.

Industrial Financing

The volume of industrial financing tends to be reduced through the practice of corporations in financing a large portion of their new capital requirements by ploughing back surplus earnings rather than by issuing new securities for cash. In the course of time, earnings so retained by stockholders are frequently represented by securities issued as stock dividends, but these are not properly included in the totals of new financing. The attempt to keep down, by legislative or judicial action, the rate of earnings on railroad and public utility investment to a fair return precludes an attempt to finance to any extent out of surplus earnings in these industries, for there are not supposed to be any substantial surplus earnings, the aim of regulation being to allow these companies to earn merely enough to attract the necessary new capital to them for expansion and improvements.

Among the various industries included in the general classification of industrial financing, however, there has been a substantial shifting of new capital requirements from older industries to the new. The following analysis of industrial financing during the five-year period, 1924-1928, gives an indication of the changes that took place:

Year	Iron, steel, coal, copper, etc.	Equipment manufacturing	Motors and accessories	Oil
1924....	$229,319,160	$19,016,100	$ 56,521,760	$187,525,968
1925....	153,928,996	13,766,000	190,063,110	282,538,338
1926....	280,382,200	30,787,500	131,573,624	499,716,415
1927....	187,054,250	23,815,000	94,788,790	425,337,500
1928....	320,575,859	9,135,000	107,653,468	263,110,305

Year	Rubber	Shipping	Other industrial, etc.	Total industrial financing
1924....	$ 2,000,000	$13,800,000	$ 524,949,923	$1,033,132,911
1925....	65,550,000	34,420,120	1,005,443,343	1,745,709,907
1926....	43,214,537	26,500,000	1,154,180,118	2,166,354,394
1927....	72,701,675	34,210,000	1,845,489,796	2,683,397,011
1928....	64,424,795	21,150,855	2,796,360,384	3,582,412,666

Financing New Industries

That much of the venturesome quality of American business enterprise in general is shown by free capital in this country is attested to by the volume of new financing for new and untried industries that has occurred during the past few years. The following table shows the amount of new issues, chain store and investment trust promotions, each in its way a new type of enterprise, during the period from 1925 to 1928:

Year	Chain store	Investment trust
1925..............................	$ 53,476,000	$ 34,070,000
1926..............................	32,346,000	75,572,000
1927..............................	88,769,000	185,793,000
1928..............................	237,913,000	715,881,000

On the other hand, there is a great danger in this market, as in others, that some new industry may become a financing "fad" of the moment. During the period in which the industry retains its popularity, practically any issue of the group can be sold. But when the bubble bursts, the industry suffers a penalty, for then it may lose all power to raise money on reasonable terms.

The radio industry enjoyed such a bubble in 1924, when practically any radio stock was readily salable. Where this "fad" stage is followed by solid growth, however, no interruption need be experienced in the ability of the industry to obtain constant new supplies of capital. The trend of chain store financing, as shown above, was accompanied by a general expansion of this type of merchandising into various lines. Thus, of the 69 offerings noted in 1928, the following lines were represented:

Type of Chain	*Number of Offerings*	*Amount*
Drug	12	$ 67,791,000
Department store	11	66,947,000
Five and ten cent	8	34,044,000
Grocery	10	29,174,000
Shoe	7	10,473,000
Restaurant	2	9,622,000
Women's apparel	7	8,464,000
Other	12	11,398,000
Total	69	$237,913,000

The financing of individual industries generally follows a fairly uniform course of evolution. In the early stage of an industry's life, capital is difficult to secure, and financing takes the form of speculative stock issues, not always sponsored by established banking houses, for the latter may be unwilling to risk their reputation and prestige with a new and untried security. Then, as individual enterprises become firmly established and earning power is more definitely developed, a great deal of financing takes place, the success of some companies inducing the public to invest in others. Finally, the industry tends to reach a saturation point, where it has expanded sufficiently to meet the normal demand for its product or services.

Furthermore, at this stage surplus earnings are sufficient to furnish a large share of the capital needed for expansion purposes. As a result, the volume of new financing in the industry tends to fall off sharply.

The railroads passed through this cycle during the first century of their existence. The utilities are still far from the saturation point; and as long as they extend their facilities they will require large amounts of new capital which must be obtained through security issues because of the limitation in earnings already referred to. The steel, automobile, and other better-established industries can secure practically all the capital they need from earnings. On the other hand, the airplane, chain store, and many branches of the chemical and amusement industries are among those which have only recently established a basis for credit and are enjoying very rapid expansion at the present time, so that they loom large in the new financing totals.

Real Estate Financing

An important component element of the new security offerings of recent years has been issues of bonds secured by real estate mortgages. While the separate real estate mortgage is perhaps the oldest popular investment medium in this country, it is only in recent years that bond issues secured exclusively by liens on land and building have become a very important factor in the investment market.

The future of real estate financing, of course, is closely bound up with the volume of building which will go on. With the growing number of large apartment and office buildings being constructed in American cities, there is naturally a tendency for an increasing proportion of the financing in any case to assume the form of a bond issue, rather than a small individual mortgage sold directly to a bank or mortgage company. The increasing proportion of new building being financed through bond issues is shown in the table on the next page.

It is very likely that the bond issue will come into increasing favor as a medium for real estate financing with the growth in size of individual projects, even though the total volume of building should decline. However, the small mort-

Year	New city construction[a]	Real estate bond issues	Per cent of bond issues to building volume
1923	$3,449,465,740	$240,613,000	7.0
1924	3,614,662,440	324,573,000	9.0
1925	4,302,696,723	722,325,800	16.8
1926	4,008,309,244	657,066,000	13.9
1927	3,541,388,042	613,609,000	17.3
1928	3,413,091,835	723,633,650	21.2

[a] Figures from 310 cities, compiled by *The Commercial and Financial Chronicle.*

gage will persist for the financing of less expensive enterprises as long as savings banks and life insurance companies are given the latitude they enjoy at present in purchasing real estate mortgages. Also, an increasing number of real estate projects will be financed through the sale of stock rather than bonds, in view of the growing favor of the public accorded such investments; and large real estate projects have proved suitable bases for such stock issues.

Municipal financing is stimulated by an artificial factor—tax exemption. Because of their freedom from federal and certain state imposts on income, these bonds are especially attractive to persons of large means who purchase them to avoid heavy income tax payments. Hence, under the stimulus of current income tax rates, municipal financing remains large despite shifts in the capital market generally.

There is no reason for expecting a drop in municipal financing, in view of the rising living standards in American cities. Attempts to take away the tax exemption feature of these bonds, which would tend to discourage their issuance, have been defeated in Congress thus far.

The Yield Factor

Some index to the changing public attitude toward different classes of securities is given by the varying level of yields on bonds in each class. The shifting general level of interest rates of course determines variations in the general level of bond yields. In recent years, municipal bonds as a class have borne the lowest average yields among new bond issues, federal government financing being ignored as it is practically entirely refunding at the present time. Railroad and farm loan issues come next in line, the latter largely because of tax exemption features. Then come public utilities, then the general run of industrials, while the highest average yield is shown by real estate bonds, chiefly because of limited marketability, but also because of the relatively great demand for funds for this purpose.

The general level of yields on bond issues in these various classes of securities has been studied in an analysis of the capital market prepared by the investment banking house of Stone & Webster and Blodget, Inc. A comparison of yields at the time of issue of thousands of bond issues showed the following comparison for 1923 and 1927 (000 omitted):

1923

Yield (Per cent)	Railroad	Public utility	Industrial	Municipal	Real estate	Farm loan
3–4	....	....	....	18,860	....	....
4–5	55,810	910	....	699,370	1,000	382,500
5–6	402,040	381,790	237,540	272,290	58,770	....
6–7	32,600	459,940	531,590	60,190	168,420	....
7	500	27,460	88,980	2,890	10,640	....

1927

Yield (Per cent)	Railroad	Public utility	Industrial	Municipal	Real estate	Farm loan
3–4	....	....	....	440,773	....	....
4–5	355,800	656,390	172,110	910,556	7,220	179,625
5–6	327,736	1,140,150	1,021,089	106,554	205,240	....
6–7	16,536	231,246	472,878	51,339	385,310	....
7	7,500	34,435	53,945	4,795	12,500	....

The varying yield levels indicated in the above table for the more important classes of bonds reflect all of those factors influencing the demand and supply for each of them. These factors include investment quality, tax position, legality for institutional investment, habits of investors, etc. By comparing 1923 yields with those of 1927, the irregular influence of a declining tendency in the general interest rate is made evident.

Stocks and Bonds

Statistics of new financing during the third decade of the twentieth century show a dominance of bond issues to 1928, a period of steadily rising stock prices and, after 1926, relatively stable and then declining bond prices. The proportion of stock issues to total security flotations is shown in the following table:[1]

Year	Domestic corporate financing (000 omitted)	Percentage		
		Bonds	Preferred stock	Common stock
1923	$3,209,710	76.6	12.0	11.4
1924	3,767,630	78.8	9.2	12.0
1925	4,261,420	70.6	15.4	14.0
1926	4,862,220	72.6	12.5	14.9
1927	6,836,926	74.6	15.4	10.0
1928	6,852,820	50.4	20.5	29.1

Within each of the major financing groups, the tendency toward stocks has been pronounced, as is shown by the following table giving the percentage of each type of corporate financing which took the form of stock in 1924 and 1928:

PERCENTAGE OF STOCK TO TOTAL NEW FINANCING

Year	Railroads	Public utility	Industrial	Real estate
1923	7.9	24.2	32.9	4.4
1928	28.1	40.0	72.3	10.8

[1] From data compiled by the investment banking house of Stone & Webster and Blodget, Inc.

The great prosperity of American industry during the years following the war resulted in a general rise in stock prices which attracted an unprecedented amount of popular speculation and which also established common stocks as an investment instrument of paramount importance. This trend toward stock financing, felt by both old and new industries, will have a profound effect upon the position of American corporations. In former days, capital could be raised most cheaply through the sale of bonds, because of the preferred position of the latter in the judgment of investors. As a result, corporations sought to bond themselves as far as possible, jeopardizing their solvency in periods of smaller earnings and exaggerating the speculative character of their stock issues. Under new conditions in which stock can often be sold on a promised yield basis as small or smaller than that given by bonds, there is no need to cut down the equity of the stockholder by the liberal creation of prior securities; and the vicious circle of trying to establish stock issues on an investment basis through liberal issues of low coupon bonds has been abandoned.

The factors behind this shift of interest to stocks and the relative merits of the two chief types of securities are discussed at length in Chapter XIII below.

Foreign Financing

When the accumulation of capital within a country proceeds at a rapid pace, it is natural that a portion of the stream of savings shall be deflected from domestic investments into foreign securities as more profitable opportunities arise abroad. This was the case in the United States after 1920, although, as was seen in Chapter VII, we enjoyed a short period of capital export before the big industrial consolidation era began in 1899. During the decade following the end of the Great War, approximately $15,000,000,000 of foreign securities were floated in this market. The amount of foreign financing, and the proportion of total new capital issues which represented foreign issues, are shown in the first table on page 229.[1]

The stream of capital destined for foreign investment turned at first to the old countries of Europe, but gradually spread

[1] Compiled by *The Commercial and Financial Chronicle.*

Year	Foreign financing	Percentage of total financing
1920	$ 538,725,887	13.4
1921	604,662,000	14.4
1922	802,799,034	15.3
1923	368,402,279	7.5
1924	1,253,625,765	19.7
1925	1,316,022,500	18.5
1926	1,360,215,540	18.4
1927	1,737,618,425	17.5
1928	1,582,982,400	15.9

over practically the whole world as the confidence of the investor increased and the lure of higher yields attracted him farther afield. Thus, the Department of Commerce reports the following geographic distribution of American foreign financing between January 1, 1914 and January 1, 1928:

Territory	Amount	Per cent of total
Europe	$ 5,653,262,025	48.5
Canada and Newfoundland	2,711,242,015	23.3
Latin America	2,426,848,849	20.8
Far East	694,771,800	5.9
Territories and possessions	173,258,840	1.5
Total	$11,659,383,529	100.0

The flow of American capital abroad has benefited both governments and corporations of other countries. The proportion of corporate financing has grown steadily, following the reconstruction of government finance in many countries after the war, making additional loans abroad unnecessary for them. The character of the industries which have been financed by foreign corporate security flotations in this country is shown by the compilation at the top of the next page.

Foreign corporate financing, as in the case of domestic issues, has shown a tendency to take the form of stock rather

Industry	Financing, 1914-1927 (inclusive)
Public utilities	$ 722,925,000
Railways	720,114,750
Banks	492,729,075
Sugar companies	347,673,990
Paper	346,769,450
Mining	239,425,500
Oil	175,524,745
Iron and steel	135,930,000
Miscellaneous	532,215,399
Total	$3,713,307,909

than bond issues, as business conditions abroad have become more stable and the desire to share in future growth of earnings of leading foreign corporations makes itself felt. Fear abroad of adverse effects from American stock control is an important obstacle to the future growth of such investment, as shown by the determined efforts in 1929 of the British controlling interests to prevent the numerous American stockholders from enjoying their full rights in the British General Electric Company, Ltd.

Other Forms of Capital Export

In tracing the volume of foreign investment, the total of new capital flotations for the account of foreign government and corporations is not an inclusive figure. In addition to these foreign securities floated abroad, large purchases of securities originally issued internally in those countries are made by Americans. Purchases of such internal issues cannot be traced, but the number of investment houses and brokers interested in trading in such securities is so large as to indicate that the aggregate is normally quite substantial. Furthermore, investment trusts put, on the whole, a sizable proportion of their funds in such foreign internal issues.

In addition to public security flotations here and the purchase of internally issued securities, the export of capital may take the form of the shifting of balances from one market to the other. This, however, is more a banking than an investment matter, although when a large volume of foreign funds is shifted to New York under the attraction of high call money rates here, for example, they may influence domestic speculative and investment conditions substantially.

A final and important channel for foreign investment is the direct investment by corporations in the property or securities of concerns doing the same line of business abroad. Thus, the Electric Bond & Share Company, a leading holding company in this country, has invested hundreds of millions in its subsidiary, the American & Foreign Power Company, which operates solely abroad. The International Telephone & Telegraph Company similarly is an American corporation, although it operates almost entirely abroad. Numerous leading American industrial companies, such as the Ford Motor Company, the General Motors Corporation, the International Harvester Company, F. W. Woolworth & Company, the Westinghouse Air Brake Company and the General Electric Company, have extensive interests in foreign countries, and through these interests send abroad a large amount of American capital which, for the most part, is not recorded in statistics on the subject.

Trends in Foreign Financing

The recent trend in foreign financing has been away from direct security flotations in this market, and toward indirect financing through affiliations and investments by American corporations in foreign property. The reasons for this will be obvious.

The normal tendency in financing methods is to adopt the channels of lowest cost. In view of the higher yields investors expect from foreign securities as compared with domestic issues, it is difficult for foreign borrowers, government and corporate—especially those whose credit is not well established here—to obtain capital on moderate terms. On the other hand, the large American corporations can raise money on very low terms for the most part, especially through the sale of stock. Thus, during 1928, corporations like the Electric Bond

& Share Company and the International Telephone & Telegraph Company raised funds for the purchase of properties abroad by selling stock here on a current yield basis of less than 4 per cent. Many of the countries in South America, to which most of the proceeds went, could borrow only with difficulty at less than 7 per cent.

It is interesting to note that German foreign investment before the war, under conditions similar to those prevailing in this country, followed to a large extent the indirect channel of corporation investment. Big German corporations like the German General Electric Company, having access to large amounts of capital at low cost through their splendid credit in the home market, did a large part, at times the bulk, of German foreign investing then. It was only in countries like England and France, where few large industrial companies with widespread markets for their securities were in existence, that the individual investor continually absorbed large volumes of foreign government and corporate bonds and thus did the bulk of foreign investing directly. Compilations made in 1928 show that in that year the aggregate of foreign investment was probably larger than in 1927, but direct public flotations were smaller. An increase in investing through American corporations was the reason.

It is generally believed that a substantial portion of the stream of new investment capital will continue to be diverted from the home market to foreign countries. On the other hand, there is no reason to believe that the volume of foreign investment established during the first decade following the Great War represents a permanent level which capital exports will maintain. During this period of reconstruction in Europe, there was a great demand for capital from that continent; and other parts of the world that formerly looked to Europe for their capital needs found that source of supply dried up. Hence, there was a world-wide shortage of free capital, and the American market had to be tapped, no matter what the cost. As foreign needs become less pressing and other markets, such as those of London and Paris, recover their capital exporting power, while domestic opportunities for investment expand, our export of capital may decline. On the other hand, a larger unused capital surplus resulting from a larger national income or reduced opportunities for domestic investment may increase the volume of capital available for foreign investment, and opportunities may arise, especially in undeveloped countries, to utilize it all profitably.

The Future for New Financing

The above analysis of new financing indicates that a number of fundamental changes have taken place in recent years. Capital flotations on the American market have tended lately to take the form of stock rather than bonds, and to represent new or rapidly growing industries. Railroads, traction companies, iron and steel companies and other industries which have seen their period of greatest growth in the past no longer absorb as large a share of the annual increment of new free capital as was formerly the case.

From what has been seen, the chief demand for new capital in this country will very probably come from new industries. The one outstanding exception is the electric power and light industry, which has assumed the leadership in new financing and will probably retain it. Real estate financing also bids fair to maintain an important position indefinitely. Lastly, foreign financing, direct or indirect, will doubtless continue to absorb a goodly portion of the annual accretion of capital in the United States.

With these established channels for the investment of new capital absorbing the savings of the country at the rate established in the last few years, it would appear that there is no plethora of free capital in sight. Experience shows that extremely low interest rates in one country do not generally persist when rates are high in other economically developed parts of the globe. With European interest rates placed on a definitely higher level as a result of the vast destruction of capital occasioned by the World War, it is very likely that any tendency for American industry to lag behind in the absorption of new capital will be offset by increased demands from abroad.

There have been recurrent periods in the past when excess free capital sought employment at very low rates. The most remarkable period was that around the turn of the century, when governments could finance at a cost of less than 3 per cent, and first-class corporation bonds yielded less than 4 per cent. This era witnessed extremely low interest rates in France, England, Germany and Holland, as well as in this country. The era of great industrial consolidations and public utility development had not started then on the scale which drove interest rates steadily higher in the period which followed. Also, investment funds were largely concentrated at that period in a relatively limited number of government and railroad bonds. With the vastly increased number of strong bond and stock issues now available, and the much more rapid industrial tempo which has been established through the growth of new industries and the consolidation of old, such a period of excess supply of capital and extremely low interest rates will probably not be seen again for many years to come.

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Chapter X

THE MONEY MARKET AND INVESTMENT BANKING

Scope of the Money Market

The term money market is usually assigned to the aggregate of buyers and sellers who are engaged in dealing in short-term loans and obligations. Included under this head are commercial and financial loans made on both a call and short-term basis. While in current parlance the term is often used in a restricted sense to denote the market for call loans secured by stock and bond collateral, the latter is really only one section of the larger money market.

It is hardly necessary to call attention to the fact that the terms "short" and "long" are of purely relative significance in any such discussion as this. The thing that is of great interest is the fact that such a distinction between short- and long-term loans and securities is made, and that it is possible to draw a rough line of demarcation between these two branches of the investment field. Securities of even short term, when issued by investment bankers, are seldom included within the operations of the money market, although short-term government obligations often are. Furthermore, the money market trades only in loans and obligations, equities being naturally excluded.

A general characteristic of the money market is the fact that loans and obligations are transferred within it in terms of a stated rate of interest, rather than in quotations which represent certain percentages of par value, as is the case in the bond market, or so many dollars for each share, as is the case in the stock market. It is true that such long-term securities as railroad equipment trust certificates and municipal bonds are also generally traded in on a yield basis, but they constitute the exceptions in the security markets. The near maturity of money market obligations and the fact that they are payable at their par value when they fall due account for this general practice of making quotations in terms of the interest or discount rate.

The price for the use of the short-term loans which are secured in the money market is, therefore, stated as a certain rate of interest. Before examining the money market in greater detail, we shall consider the general rôle played in it by the interest rate.

Definition of Interest

The definition of interest has formed the subject of extended discussion among economists and students of finance for many years, but there has been no definite agreement as to the "cause" of interest payment. There is agreement that in ordinary competitive societies, with private ownership of wealth, a payment made by the active user of wealth to the owner of it is necessary in order to insure the maintenance both of the amount and of the availability of wealth adequate to the current needs of industry.

It is also agreed that, within broad limits and subject to some limitations which at times become serious, a change in the amount thus paid tends to determine the sum so made available. This result is brought about in two ways. A higher rate of interest or interest payment may result in inducing persons to work harder, and so in producing more wealth which may be used in lending; or it may induce them to refrain from consuming the funds they already have, instead devoting these funds to productive industry by lending them to persons who are willing to pay for them. Conversely, a reduction in the rate of interest tends to slow down the amount produced or the amount of the existing fund which is turned over to industrialists. Accordingly, the rate of interest is looked to as a partial means for bringing about the regulation of the amount of actual new capital which is coming forward for investment, and the amount of such capital which is being used in short-term channels, as compared with the amount which is being used in long-term channels. The rate of interest is thus to be looked upon as a regulator or governor of the industrial or financial machinery of a community.

Evidently, this kind of definition necessitates a conclusion as to what limits the interest rate. Substantial agreement prevails to the effect that a rate cannot be paid in excess of the capacity of the borrowed capital to reproduce itself; that is to say, the limit of the rate that can be paid at any time is the amount of new wealth or additional productiveness which can be obtained through the application of the capital in business and industry. This notion is evidently almost axiomatic when it is stated in this broad way. The difficulty with it is found in the fact that nearly every industry differs from every other with regard to the amount of additional productiveness that could be obtained through the use of more units of capital. Nevertheless, it is not true that the rate of interest is changed according to the productiveness of funds in any given industry, any more than that the price of food is changed according to the needs of any one individual who is buying or consuming it. The capital market, of which so much has already been said, "irons out" these differences in a broad way, and establishes a relatively uniform rate which is to be paid by those who want new capital. It does not produce an absolutely uniform rate, there being still differences which are due to the degree of security that is offered to the lenders, and other factors. But it eliminates the great differences which would exist between rates if they were left to depend upon the ability of those who are using them to produce actual increases in wealth.

The first general rôle of the rate of interest is to regulate the total amount of funds which is offered and sought. But as this rate is not uniform but differs for various kinds of loans, it performs a second function in regulating the proportion of loanable funds which are available for any one specific kind of loan in the money market. In fact, the market is a competitive one, and each user or group of users undertakes to protect itself against others by offering higher or lower rates for the funds needed. As a matter of fact, we never have a single rate of interest in any market; we have a variety of rates which have been adapted to the particular kind of loan for which they are intended, and which represent the notions of the groups of traders with respect to the relative urgency or desirability of that particular use as compared with other uses which are to be contrasted with it.

These varying rates of interest fluctuate greatly, not only absolutely but in relation to one another among themselves. The study of the rates, or "rate structure" as it may be called, in any given community furnishes the clue to the actual distribution of funds at any given time and, of course, to the underlying conditions which determine the willingness of traders in that particular branch of the market to pay more or less for what they want. Accordingly, the prevailing practice of business and finance has been to deal with the rates of interest as "indexes," and to guide business operations more or less in accordance with the fluctuations of these rates, even though it may be true at times that there seems to be no necessary reflex effect following from the changes in such rates upon the business community, due to lack of time within which such effect might have made itself felt. Just as a thermometer measures the temperature in a room, and may lead by mechanical contrivance to alteration of the inflow of air before those in the room have had time to feel very uncomfortable, so the rate of interest is an indicator to determine the time and conditions in which alterations of the supply of, and demand for, capital take place, and corrective steps may be taken if interest rate changes indicate that abnormal conditions may develop in the business structure.

Any one type of interest rate is determined therefore by the relation between the two factors of supply and demand affecting it. What has not been made so obvious is the fact that in each type of specialized market highly local conditions of demand and supply constantly vary among themselves in a fashion which is reflected in the fluctuating rates named there from day to day. Thus, for example, we may give first attention to the rate which is charged by banks for loans to their customers.

In any given case, the price of such loans results from a comparison of the demand and supply of bank funds, and this demand may be the outgrowth of sudden calls for immediate resources at times when banks are already "loaned up." On the other hand, banks may suddenly receive great accessions of funds which enable them to offer loans at low rates in order to induce customers to borrow more heavily than they otherwise would. The banker has a definite overhead cost in making his loan which he must always cover; but above that there is a large field of fluctuation or uncertainty within which variation is caused by the changing conditions referred to. In the United States rates for straight bank loans on unquestionable security seldom go below 4 or 4½ per cent; but in some parts of the country they may be as high as 10 or 12 per cent, even when the security is paper of an irreproachable character. In Germany during recent years bank rates have sometimes gone to fabulous figures as high as 90 or 100 per cent; but this was due to instability of the currency, so that the banker had to allow for the probability that he would receive money of a much lower purchasing power than that which he had advanced to the borrower.

Types of Loans

With these general considerations concerning interest rates in mind, we shall now turn to a survey of the different sections of the money market, each of which has its own particular rate. Seven important sections in the money market can be distinguished on this basis. They are:

1. The call money market, for loans secured almost exclusively by stocks and bonds
2. The time money market, which is also a security collateral loan market
3. The market for short-term government securities
4. The market for bankers' acceptances
5. The market for negotiable commercial paper
6. "Over-the-counter" loans by banks to their regular borrowing customers
7. The market for credit at the central bank—in this country, credit at a reserve bank which member banks may secure through the process of rediscounting, as provided by law

It is seen that the money market is largely a market for the kinds and classes of credit with which commercial banks have to deal, as distinguished from those with which purely investment banking institutions are more directly concerned. The bank, particularly the American bank, has its own "market" which consists of its own group of customers, while the money market in the broad sense comprises what is also termed the "open market," which includes all those who are engaged in dealing in obligations which are suitable for bank holdings. The investment bankers and the brokers have contact with the commercial bankers in the open market, since they borrow from him there; and the commercial banker on the other hand buys in the capital market investment securities which he holds as a means of employing his surplus funds when they are not needed for the accommodation of his own customers. From this point of view, the money market acts to equalize the supply and demand of funds between the commercial and investment banking spheres. This assigns to the money market a vital special function which endows it with exceptional importance at certain periods, as discussed more fully in Chapter XII on investment credit control.

Call Loans

Call loans are loans which are repayable at the option of lender or borrower within twenty-four hours' notice. When not called, these loans may continue in force indefinitely. A special significance, however, has been given to the term "call funds," so that it is now applied to funds lent on demand notes subject to only one day's maturity, with the understanding that they are to be embarked in the stock market for use in purchasing and carrying the securities which are there traded in. The term call funds or call loans is sometimes practically identified with brokers' loans, although not properly so, the term brokers' loan referring specifically to call loans which have been made to brokers in the expectation that they will be reloaned to customers who are engaged in dealing in securities on margin.

Theoretically speaking, a bank might make considerable amounts of call loans directly to individuals who want to use them in carrying securities. These securities may be hypothecated with the bank to protect the loan, with the understanding that they are likely to be withdrawn at any time and others substituted for them, thus enabling the customer to buy and sell securities with only a small part of the needed funds in his own possession, the bank furnishing the balance by way of loans. It should be added parenthetically that, partly due to the fact that the bank is not always as willing to advance its funds in this way to so great an extent or on so small a margin as the broker, and partly due to the fact that the complication and detail of handling loans in this way are much more involved for the borrower than where he deals through a broker, banks are not ordinarily called upon to furnish any very large volume of funds in this direct fashion for the financing of purely speculative operations. They furnish it rather to the broker, and he in turn relends to the customer, carrying on the relationship with the bank himself and depositing new collateral whenever he sees fit and the exigencies of his business with his customers demand. Direct loans by banks to security holders do loom large in the case of unlisted issues, but they are in the main on a time basis.

Up to this point any "market for call funds" we have considered has been a purely theoretical one, since it has involved only two parties, the banker and the borrower, whether the latter be a broker or an actual speculator. The term "market" begins to have a genuine signification in the broader sense of the term only when the broker or other borrower endeavors to find out where he can get his funds most cheaply and "shops about" for the purpose of making the most satisfactory and most profitable connection with an actual lender of money. This kind of market development may be brought about through the efforts of money brokers who mediate between lenders and borrowers. In the New York market, however, it has been provided for through the establishment of a "money post" or, more recently, "money desk" on the floor of the New York Stock Exchange, at which offers of and bids for money are received, and lenders and borrowers brought into contact with one another to the end that demand and supply may be equalized and that rates may be adjusted one to another. Evidently this kind of adjustment, aiming as it does at an equalization of demand and supply over very short periods, results in establishing a highly sensitive rate, that is, a rate that is very responsive to the effect of changes or fluctuations in the relationship between demand and supply.

As a matter of fact, the great bulk of the call loans made on the New York money market, the dominant money market in the country, are made at the rate fixed at the money desk of the New York Stock Exchange. Each morning at 11 A. M. a "renewal rate" for call loans is determined by the Stock Clearing Corporation, based on expectations of what the supply of and demand for funds will be during the day. Any borrower or lender not satisfied with this rate can call his loan and make a new loan in the market. During the day, brokers file applications for new loans at the money desk, while banks, through friendly brokers, turn in offers of money at various rates. When the supply of funds at one rate is exhausted, the rate rises. Conversely, if the demand for funds can be satisfied out of offers made at a lower rate, the official rate declines. Many loans may be arranged also on the "outside market," that is, directly from banks or through money brokers off the floor of the exchange.

Time Loans

The market for time funds, consisting of collateral loans running from 30 to 180 days, does not differ in any important respect from the call loan market.

The trading takes place at the hands of the same group of dealers and operators, and the factors of demand and supply are very much the same in both cases. Differences in rates for the two types of loans are primarily due to the fact that borrowers themselves at times shift their demand from call to time funds and back again, according as the situation in the speculative field seems to indicate the probability of early changes in the call money rate. Trading in time funds is resorted to as practically an insurance of a steady money supply at a given rate for a specified period; or, in other words, it may be viewed as a forward order for call money. It need not, therefore, be given any very extended treatment, so far as its technique goes, by students of the investment banking situation.

There is one phase of the time money situation which, however, is worthy of special study. This is the function it performs in bridging the gap between call money and the shorter-term forms of investment paper. As a rule, the time money rate is higher than that for call money, and is intermediate between the call rate and the rate on short-term investment paper. This intermediation is not of course permanent, for at times both the call and the time rate may temporarily be pushed considerably higher than the investment paper figure, as happened in 1928 and 1929. But in normal times the lowest rate in the open market is usually that for call money; time funds are slightly above it, and short-term investment paper occupies a still higher stage in the general scale of rates prevailing at any time in the market.

Time loans become relatively unimportant when the rate moves up above 6 per cent for any period of time, because such loans are not exempt from the usury law, which in New York State provides for a maximum rate of 6 per cent on loans to individuals and partnerships, except in the case of call loans of more than $5,000 secured by collateral. In the case of a time loan, when more than 6 per cent is charged, the interest is not collectible at law. Hence, the volume of time loans declines sharply in periods of high interest rates, being made chiefly to first-class firms who would not, it is supposed, contest the payment of interest under any circumstances.

Supply of Funds

The great expansion in the volume of security trading during recent years has created the need for large amounts of call and time funds. These funds have been supplied from various sources, so that between 1923 and 1928 the volume of loans to brokers more than trebled. As increasing interest came to be centered upon these loans because of their rapid expansion and their importance in the business and speculative situation, regular statistics began to be published. At the present time, the Federal Reserve Bank of New York furnishes weekly the total of loans made by the large New York member banks for their own account and for others. These figures are issued Thursday afternoon for publication in the newspapers Friday morning. The New York Stock Exchange makes its own compilation of brokers' loans made to its members from all sources, and this appears monthly, shortly after the beginning of each month. Neither of the two statements is comprehensive. The statement of loans made by and through New York member banks does not include advances made directly by money brokers and others outside of the forty-odd large metropolitan banks, nor does it include loans made out of town. The monthly statement of the New York Stock Exchange fails to include loans from whatever source made by

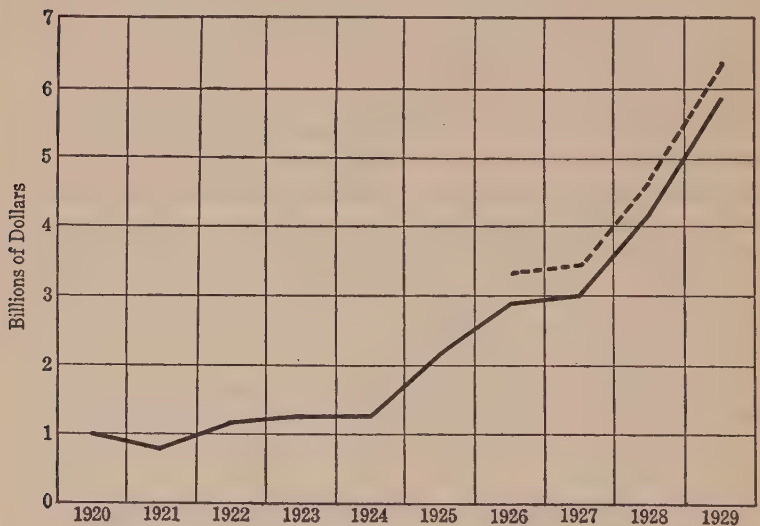

Fig. 8. Brokers Loans (yearly average, 1920-1929)
——— As reported by the Federal Reserve Bank of New York
------ As reported by the New York Stock Exchange

others than members of the exchange. The above figure traces the movement of both of these brokers' loan totals.

Analysis shows that the sources of these loans are, first of all, the metropolitan banks which in normal times do the bulk of the lending either for themselves or for the account of others; secondly, the out-of-town banks, including both domestic and foreign institutions; and, thirdly, a group of large corporations and moneyed individuals who make loans in the call or time market in order to occupy the funds which they have free and available for such purposes. Of course they can be regarded as the source of such funds only in a general sense. The ability of banks to lend in this way depends on the surplus funds left with them by their other customers, and thus in a real sense the true source of supply of the money market is found in the depositors of the banks, rather than in the banks themselves.

These depositors can, and sometimes do, determine the calling of loans by the activity of their own demands on the banks for the liquidation of their deposit claims. In addition to this ultimate source of supply of funds, however, there is in every central banking country a reservoir of credit furnished by the central bank of the country, and hence within its power to supply or withhold. In the United States this reservoir is held by the Federal Reserve System. Federal Reserve Banks are forbidden by law to lend for speculative purposes, or on demand. Nevertheless, they do habitually supply money to the stock market by permitting their member banks to rediscount with them paper collateraled by government securities and, to some extent, that furnished by customers which has been made eligible for rediscount under the present regulations. Purchases of government securities and bankers' acceptances in the open market have a similar result.

Reserve banks do not habitually inquire how much of their customers' loans are actually being used for stock market purposes, although of course they have ample opportunity and power to inform themselves regarding this. As a rule, their contributions to the money market may be measured by the volume of acceptances or government securities they are buying, combined with the volume of loans which they are making on the direct paper of member banks protected by collateral of any kind. On the other hand, their contributions to the support of the commercial community, so far as these can be directly measured, are indicated by the quantity of rediscounted paper which they hold. These indications are very rough and are only approximate, but they are sufficient to furnish some indication as to the trend of affairs when comparison for a series of dates is made in such a way as to get the changes in direction which are revealed by the figures.

The following table furnishes the average weekly figures reported by the Federal Reserve Bank of New York in January of each year since the institution of this system of reporting, while the table next following reproduces the figures published by the New York Stock Exchange as already set forth above:

LOANS TO BROKERS AND DEALERS BY REPORTING MEMBER BANKS IN NEW YORK CITY (000,000 OMITTED)

Date	For own account	For account of out-of-town banks	For the account of others	Total
Jan., 1926	$1,259	$1,281	$ 585	$3,125
Jan., 1927	933	1,104	741	2,778
Jan., 1928	1,342	1,470	990	3,802
Jan., 1929	1,516	1,648	2,166	5,330

NEW YORK STOCK EXCHANGE REPORT ON LOANS TO BROKERS

Date	From New York banks and trust companies	From private bankers, brokers, foreign bank, agencies and others in N. Y. City	Total
Feb. 1, 1926....	$3,043,044,309	$ 470,129,845	$3,513,174,154
Jan. 1, 1927....	2,803,585,266	489,274,989	3,292,860,255
Jan. 1, 1928....	3,811,809,708	621,097,613	4,432,907,321
Jan. 1, 1929....	5,400,797,909	1,038,942,602	6,439,740,511

Source of Demand

It is worth while to make some analysis of the sources of the demand for these loans which, taken together, make up this great sum. One such is, of course, found in the brokers who borrow for speculating customers. Under existing American practice, those who wish to purchase securities and are unable to pay for them in full—"margin traders"—place their orders through a broker with an understanding that such broker shall furnish the amount of money over and above a necessary margin which constitutes the basic element or insurance against loss from depreciation in value. The broker obtains the needed funds from his bank, depositing with it the securities he purchased, as collateral to protect the loans. Therefore, the volume of brokers' loans will vary with the amount of stock trading.

The amount of such loans is further increased by the great expansion which has taken place in the number and size of listings on the New York Stock Exchange. It must be remembered that brokers carry on margin for their customers only standard listed stocks, many of them discriminating even against securities on the New York Curb Market; few, indeed, carry unlisted securities of even high quality on a margin basis. The relation between brokers' loans and the total market value of listed shares is shown in the following table, indicating that the increase in loans shown in the preceding tables was only proportionate to the expansion in such market value:

PER CENT OF NEW YORK STOCK EXCHANGE LOANS TO TOTAL MARKET VALUES OF LISTED SHARES

Date	Total market values of listed shares (000,000 omitted)	Per cent loans to market value
February 1, 1926	$35,179	9.98
January 1, 1927	38,376	8.58
January 1, 1928	49,736	8.91
January 1, 1929	67,472	9.54

A second element of demand is found in the case of issuers of new securities who borrow from banks for the purpose of getting funds with which to carry unsold balances of the new issues which they have obligated themselves to dispose of. If, for example, an issue house has undertaken to sell $5,000,000 worth of bonds, but has actually sold only $4,000,000 prior to a certain time, it will be under obligations to obtain the additional $1,000,000 and place it at the disposal of the seller by the specified date. It will get the sum needed by borrowing from its banker on collateral, and this sum will be reported as a "brokers' loan," although it is such only by courtesy. While figures at present available do not permit the precise valuation of the relative importance of these different sources of demand, they do show that the loans to brokers (in the technical sense) may be estimated as exceeding $7,000,000,000 at the present time. The total is probably roughly divided between brokers and issue houses in a proportion which is estimated as varying from five to one to eight to one, although the situation changes continually, and no exact measurement is possible.

In connection with these brokers' loans, it is well to bear in mind that they do not represent by any means the total volume of credit which is being absorbed in security loans. The total volume of bank loans made with security collateral is above $13,000,000,000, some portion of which represents ordinary business loans with security collateral to safeguard them. But there is also a large portion of this bank credit, aggregating perhaps $4,000,000,000 at the present time, which represents direct loans made by banks to investors and traders who wish to carry securities with the aid of credit pending their rise in price. These direct loans, most of which are on a time basis, should be added to the brokers' loan total to determine the total volume of bank credit used in carrying securities.

Other Sections of the Money Market

Special attention has been given to the call and time loan sections of the money market, because of their intimate bearing on the investment banking business.

The rate on short-term government securities reflects the price of the highest grade of credit in the market. The government certificates of indebtedness are held chiefly by banks and large corporations, but the Federal Reserve Banks are also buyers and sellers, doing one or the other according as they wish to make the money market more or less easy.

The bankers' acceptance, which is now widely used in foreign trade financing, also represents a virtually absolutely safe instrument. The rate on bankers' acceptances, however, sometimes does not accurately reflect the state of the money market. The Federal Reserve Banks at times buy them heavily, and this has an important effect on conditions in the bill market, since there are only about $1,200,000,000 of such bills outstanding on the average at any one time.

Attention may next be given to the market for commercial paper. As broadly used, this term is frequently interpreted to signify any paper that is made by commercial borrowers who obtain funds in one way or another from the banking community on short term. Thus, straight customers' notes held by a bank are frequently referred to rather loosely as commercial paper. Of recent years, however, the term has come to have a very definite and special significance. In this narrower and more professional sense, it implies a kind of paper which is made and placed upon the market for the purpose of providing current funds or working capital for enterprises which do not care to borrow from their local banks, or who prefer to get at least a part of their requirements without recourse to them. In cases of this kind, the borrower may be able to induce his local banker to continue financing his purely temporary and occasional wants, while he provides himself with his longer-term loans in the open market; or he may find that the banker is not willing to divide his business with others in that way, so that it becomes necessary for him to confine himself entirely to open market dealings in order to get the funds he currently requires. In either case, however, the borrower finds it necessary to determine a lump sum requirement which will practically cover his necessities and enable him to proceed vigorously with his business.

Having decided upon the amount needed, he thereupon discusses the matter with so-called commercial paper houses. Such a paper house examines carefully into the credit of his business and, having made up its mind with respect to the extent of its title to credit, determines, if favorably impressed, to undertake the sale of commercial paper in the specified amount. Having thus committed itself to the financing of the enterprise which has made application to it, the commercial paper house may regularly purchase the paper of the would-be borrower and then undertake to resell it again. In other cases it may not care to do this if the paper is very large in amount, but may prefer to act as a broker or an intermediary, simply taking the paper over and selling it as it has opportunity.

It is thus seen that the commercial paper market is one which reflects more accurately the supply of and demand for funds, and is less subject to artificial conditions than the rate on government securities and bankers' acceptances. Because of the larger firms involved and the more organized character of the market, this rate is generally lower than the "over-the-counter" loan rate of banks on direct loans to their customers.

The Federal Reserve rate reflects the cost of reserve credit to member banks who wish to borrow at the Federal Reserve Banks. As this involves the whole question of investment credit control, it will be considered more fully in Chapter XII below.

Typical Rates of Interest

We may now sketch very briefly the major or typical rates of interest in the New York money market. First of all, we have what may be called the basic rate representing practically pure credit or credit free of any elements of risk—except, of course, that possibility of risk which is always present in any enterprise involving human action. We may perhaps take the rate paid by the government upon its own obligations as fairly representing this basic cost or worth of money. The interest which the buyer of government bonds receives is the payment made to him to induce him to part with his wealth for governmental use. He is as free of danger concerning non-payment of his loan as it is perhaps humanly possible for him to be. On the other hand, he has no security except the underlying protection of a strong and wealthy country with almost unlimited taxing power. However, exemption of the income from taxation results in such securities selling at a lower yield than would otherwise be the case.

We then have four major factors which tend to bring about different types or rates of interest. They are (a) differences in time; (b) differences in security; (c) differences in taxable liability; and (d) differences in liquidity of the obligation under discussion. To one or another of these major differences may be ascribed practically all of the variations in rates which are actually noted in the money market.

While differentials between the different rates vary according to the forces of supply and demand operating in each section of the money market, some idea of the relation of each of the rates may be gathered from the following list of rates as of July 1, 1929:

	Per Cent
Call money rate (renewal)	10
Time money rate	7¾–8
Yield on U. S. certificates of indebtedness	4.80
Bankers' acceptance rate	5½
Federal reserve rediscount rate	5
Prime commercial paper rate	6

Some International Aspects

The state of affairs just outlined has also some significant international aspects which deserve at least passing comment. There has been a strong tendency of recent years to internationalize money and capital markets, so that the chief centers which were formerly definitely separated one from another now tend to become in a real sense sections of one international market. There are several factors which have worked powerfully to bring about this development. One is the growing number of banks which possess foreign branches, which have created agencies or named foreign correspondents who work in direct harmony with them abroad. It is true that after the hasty movement in the establishment of foreign branches by American banks following the World War, there was a retrograde movement resulting in the curtailment of these branches, a good many of them going out of business. This has often been spoken of as representing a real decline of the interest of American banks in foreign business. It was, however, rather a change in the direction of such interest, for the effort to establish close and intimate relationships with foreign institutions is now more intense than at any former time.

Foreign banks, moreover, have greatly increased the number of their branches in the United States, that number, including both branches and agencies, being now estimated at 150. The international coöperation of central banks has also tended in a like direction. Summed up, the present situation is one marked by the increasing internationalization of banking. In consequence of this, there has been a steady and growing process of transferring bankers' balances from one market to another. This has tended to adjust differences in rates of discount and interest, so that the inflow and outflow of foreign funds is one of the chief factors in the New York money market.

One phase of this tendency has been the creation of a truly international bill market. Federal Reserve Banks have purchased in the past considerable quantities of foreign currency bills as an aid in the process of stabilization of currencies. To a far more important extent, foreign banks have become large buyers of American dollar bills in this market, believing that in so doing they were placing their funds where they would be safest. The greater prevalence of the gold exchange standard has enabled foreign banks to make use of portfolios of bills stated in dollars or sterling and of balances on interest in American and British banks as reserves, taking the place of gold held in their own vaults. It remains true that gold movements of considerable amounts still continue between markets, but the processes to which reference has been made above have tended strongly to reduce their scope.

The markets for securities have not been quite so highly internationalized, partly because the investor is more cautious and less well informed than the banks and financial houses which make up the chief constituents in the money market. Nevertheless, it remains true that the necessity of drawing funds from abroad for the purpose of aiding in post-war reconstruction, and the process of buying and holding foreign securities in order to get a larger return than can be had domestically—a policy now widely pursued by investment trusts and other corporate investors—are going far toward the internationalization of capital markets along lines parallel with the corresponding unification of the money markets. Legal and administrative obstacles to such internationalization are still of considerable significance, but are steadily being reduced; and steps have been taken toward bringing about a certain degree of international unity of action as regards taxation.

It is still a fact that wide discrepancies both in money rates and in rates of yield on securities exist between the chief capital markets of the world. They are likely to continue, but the differences between such rates represent to a growing extent differences in risks of various kinds and other extraneous elements, rather than variations in the true interest on capital, which has been standardized to a considerable extent through international competition in the ways set forth.

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Chapter XI

SPECULATION AND MANIPULATION

Investment *vs.* Speculation

Few economic concepts have been subject to so much confused thinking as speculation. Much of this confusion arises from the fact that what constitutes a speculation from the viewpoint of the individual does not necessarily affect the capital market as a whole in a way different from an ordinary investment. In this chapter, an effort is made to distinguish carefully between these two aspects of the term, and to trace in detail the precise effects individual speculation has on security price movements.

From the social standpoint, or that of the capital market as a whole, an investment may be defined as any commitment of funds, whether in one's own business or in securities. This appears to have been the original meaning of the word in financial parlance. In this broad sense, the term investment carries no added implication of safety. From the standpoint of the capital market as a whole, in fact, all commitments of capital are of equal importance and constitute investments, regardless of the risks that arise for the individual investor. It is at least equally important that capital be forthcoming for new and untried enterprises, such as airplane lines and the exploitation of new inventions, as that it be available for old, established public utilities to permit them to make extensions to their service. Both represent an investment of the free capital of the community in what are meant to be productive enterprises.

From the viewpoint of the individual investor, on the other hand, there is a sharp distinction between investment and speculation. This distinction is one of the degree of risk involved in the commitment made; for the investor, if his security is fully protected, is not vitally concerned with the use to which his funds are put by the borrower. Where the risk is small, the process is called investment; as the risk increases, the commitment becomes more and more speculative.

An initial difficulty arises, however, in attempting to draw a distinction between these two terms because it is no easy matter to tell in advance how large a degree of risk attaches to any specific security. It is easier to be wise after than before the event. The intention of the buyer of securities to invest rather than to speculate, through the avoidance of risk, may not prove successful. Many an investor in high-grade government bonds, has fared badly. Buyers of Liberty Bonds during the World War, who paid par for their holdings, saw the quoted price of the bonds decline to 85 shortly after the war. Buyers of Russian government bonds before the war, when these bonds were considered a high-grade investment, saw their holdings practically wiped out. But holders of these bonds bought them as investments, and few will deny that these buyers must be included in the category of investors. It is necessary to distinguish, therefore, between the intention of the security buyer in making the original commitment and the final outcome of the transaction.

Considering merely the intention of the security buyer, investment may be defined as the *purchase of securities or other income-producing wealth with the intention of avoiding all substantial risks.* Generally the investor finds that he must be satisfied with only a moderate rate of return on his capital in order to achieve this aim, although a well-informed investor naturally will frequently discover opportunities giving large promise of income and profit, but which nevertheless involve so slight a degree of risk as to constitute the commitment a pure investment.

Speculation, on the other hand, may be defined as the act of consciously assuming risks to secure a profit which is expected to result from the favorable outcome of the enterprise in which the risk is assumed. Speculation thus becomes a matter of judging risks and choosing those which offer the promise of largest returns for the degree of uncertainty involved.

Gambling is an activity of an entirely different sort. It consists in assuming risks for their own sake, without specifically evaluating them. By almost general consent, the man who takes a "flier" in stocks, by which is meant the purchase of shares for quick and very large profits utterly without knowledge of what they represent, is termed a gambler. And this distinction appears only fair to that other type of individual, the speculator, who is engaged in delicately weighing risks in order to pick that which offers the largest measure of profit in return for the degree of uncertainty involved. The gambler *par excellence* is the player at cards or dice, who artificially creates risks having no relation to business activity, and eliminates as far as is reasonably possible the elements of judgment and foresight. It is also properly used to define all kinds of wagers, such as those on the outcome of horse races and other partly foreseeable events, where the individual does not take an interest in what is purposed to be a money-making, or so-called productive, enterprise.

The distinction between investment and speculation cannot be made on the basis of intention alone, however. It is further conditioned by the *degree of knowledge* which the security buyer possesses. To one without any knowledge of security values, any commitment, unless made in accordance with expert advice, would be a gamble. This would be the case, for example, with the widow depicted in the trust company advertisements, brought in contact with financial matters for the first time in her life through the death of her husband. She may use her funds to buy a Liberty Bond, or she may put her money into fraudulent oil stocks; but in either case she proceeds, at least until enlightened by some financial adviser, wholly in the gambling spirit. On the other hand, to the banker, with his special sources of information and his expert judgment, a wildcat oil security which he has made the subject of special investigation may be a good investment. He has evaluated the risks, having the knowledge to do so, and has perhaps found that they are virtually non-existent.

An investor, then, is one who commits his funds in such a manner as to seek to avoid all major risks. The speculator purposely assumes risks. Exactly what constitutes risk to each individual, however, depends upon his knowledge of the circumstances surrounding the safety of the commitment. Where such knowledge is wholly lacking, the commitment is a gamble. In investment, where individual knowledge differs so greatly, "one man's meat is another man's poison."

Criteria of Speculation

The definition of speculation advanced above draws no clear-cut demarcation between it and investment. Many attempts have been made to define arbitrarily the border line between investment and speculation. Thus, one writer asserts that an investor is one who is satisfied with a return equal to a theoretically pure rate of interest, as approximately fixed by the yield of government bonds, plus a "premium for risk" equal to this amount. If government bonds yield 4 per cent, an investment, according to this definition, yields up to 8 per cent, and a speculative security is one yielding more than that figure. Such a distinction is utterly useless, for it is based upon a series of *a priori* assumptions without foundation in fact. The yield on a government bond is not the pure rate of interest, for there are a number of factors entering into the determination of the price of such a bond, such as tax exemption, legality for institutional and trustee investment, and the fact that it is generally known to all investors, which may well depress the yield to far below any tenable "pure rate of interest." But even more important is the fact that there are many securities on which the yield is not much greater, and often far less than that on government bonds, but which are, to those able to appraise the situation fully, quite speculative.

There is another test frequently used as a touchstone to distinguish between investment and speculation. Buying for income, it is said, constitutes investment; buying for appreciation, speculation. This view is not always tenable in the light of actual facts. Some of the most conservative of investors buy securities which give little or no return, but which they feel are certain to appreciate in value. Standard Oil stocks and stocks in many banks and insurance companies are in this class. In fact, many of our most conservative corporations prefer to reinvest a large proportion of their earnings in their business, and consequently pay relatively small dividends. This results in a small yield but a steady appreciation in their common stocks. Conversely, many bonds bought solely for income give a very large current yield, but constitute outright speculations. It is true, however, that the great bulk of speculative security purchases are made in the hope of quick capital appreciation, rather than larger current income. Similarly, practically all short sales are speculative. The speculator, in search of large profits from the assumption of risks, naturally prefers to carry the risk for as short a time as possible.

A final test frequently applied to determine this point is whether the commitment is made in whole or in part with borrowed capital. The security buyer, as already indicated, makes an investment if he knowingly avoids all reasonable risks. When he uses borrowed funds to help pay for the securities, he increases the risk in the hope of larger profits. But this fact does not *per se* make the commitment a speculation. Those who borrowed at the banks to buy Liberty Bonds during the war—and millions of investors did so—were not necessarily speculating. It is true that there is an additional element of risk in that the loan might become payable at a time when the bonds show some depreciation in market value, but this risk may be so small as to be negligible. Furthermore, when an individual buys securities on margin with the purpose of paying for them in full during a period of time, he may be said to make an investment on the installment plan.

While these latter two criteria are not absolute distinctions between investment and speculation, they do furnish approximate tests of such transactions. The bulk of speculative security transactions are made for rapid appreciation, and they are made on margin.

Ubiquity of Speculation

Speculation has been described above as the conscious assumption of risks for the sake of gain. The term has often been applied exclusively to trading in organized markets for stocks and commodities. While here speculative activity is highly developed, it is a mistake to distinguish speculation on the exchanges from the assumption of risks in any other form of economic activity. The risks of the security markets, in fact, largely reflect those inherent in the business structure generally.

The element of speculation, it is conceivable, could be entirely eliminated from economic society. But this would involve the development first of an absolutely static state of society, such as that conceived at times by the classical economists. If it were possible to eliminate first, changes in population; secondly, changes in the volume of production of agricultural and mineral products, and thirdly, changes in technology and money and credit conditions, such a static state would be largely realized and speculation would die a natural death. Lacking such a consummation, every effort to curtail speculation has proved ineffective, and has often defeated its purpose by stifling production and trade.

The speculative nature of business in general has been particularly stressed in the economic discussions of the past two decades, in which the "business cycle" has played so prominent a part. Much of the business-cycle analysis has been presented with a view to enabling the individual business man to avoid its adverse effects through a proper speculative policy. In part, this consists in avoiding speculative risks by cutting down inventories in times of activity and rising prices; and in part it involves the assumption of risks at the right time through anticipating shortages and higher prices of labor and materials.

As economic organization becomes increasingly complex, risk-bearing becomes a more and more specialized function. Institutions are organized to reduce and eliminate certain of the risks—whence the growth of insurance in its various phases. By means of more effective social control through private and public agencies, risks may be reduced. Coöperative marketing and similar schemes have been advanced as methods of reducing the large innate risks of agriculture, while risks arising from money and credit changes are reduced through central banking. Again, where risks cannot be avoided by being spread over large sections of the community, they can be shifted from the community in general to a small group who specialize in assuming them for the sake of profit. This is the case on the exchanges. Finally, through the spread of information, risks resulting from ignorance or inability to appraise the uncertainties of a situation are reduced.

The tendency under present conditions, therefore, is for risks to increase because of the growing complexity of economic life, and at the same time to be reduced, as far as the individual is concerned, by the social agencies mentioned above.

Speculation in Securities

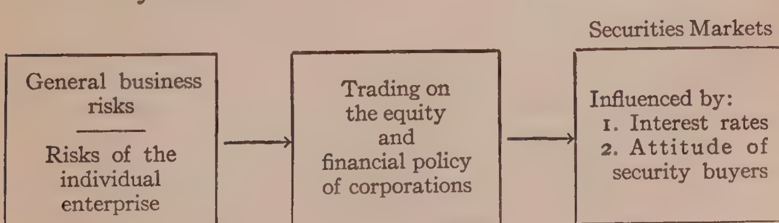
Securities represent claims to money or to property of present or potential income-producing capacity. As such, they reflect in each case not only the risks inherent in the enterprise or governmental credit which they represent, but the additional ones incident to the market in which they are traded. To cite one example of thousands which might be mentioned, Argentine railroad stocks lost the greater part of their quoted value on the London market in the early years of the war because the British holders in many cases had to sell them, and a market existed for these securities nowhere else in the world. On the basic risk of the enterprise were superimposed the additional risks peculiar to the security market.

In order to redistribute and allocate the risks in the security markets, financial practice has developed a number of devices. The most significant one from the point of view of risk-bearing is that of "trading on the equity," a term borrowed from legal usage and connoting in its broad sense the raising of funds on a comparatively low cost basis through the issue of prior claims to income or assets. The junior security holders thus assume greater risks in the hope of securing larger profits through the sale by the enterprise of bonds and preferred stocks. "Trading on the equity" denotes that part of the issued securities of the company are given what is meant to be an investment status, while the junior issues bear more than their share of the speculative risk in return for greater ultimate profit possibilities. It thus becomes possible to segregate most of the risk element, to be borne by those willing to specialize in assuming it for the sake of a larger possible return.

An important factor of uncertainty resulting from this present-day financial practice is the effect of variations in the purchasing power of money. Trading on the equity involves the issue of bonds and preferred stocks with generally a fixed annual income. The common stock is entitled to all the residual income. Any pronounced decline in the value of money thus reacts very unfavorably upon the fixed-income-bearing security in the enterprise, while a rise in the purchasing power of the dollar has an opposite effect. This is more fully discussed in Chapter XIII.

A second factor affecting the distribution of risks within the corporation is the financial policy followed by its management. Where a corporation builds up large reserves, puts its plants in excellent shape and pays dividends only after these requirements have been fulfilled, it is placing a cushion of financial strength between the corporation itself and its security holders, so that shocks felt by one are passed on to only a small extent, if at all, to the other. In other cases, the ordinary risks of the enterprise are multiplied many times over by a policy of alternatingly over-paying dividends and sharply retrenching for the purpose of physical rehabilitation.

The distribution of risks through methods of capitalization thus determines the types of securities issued by corporate enterprises. These securities are then bought and sold in the market, and their quotations are placed at the mercy of the multiple forces which determine fluctuations in prices. These forces are numerous, and at different times play more or less important parts in determining market values. The two major market factors, as distinct from changes in business conditions, are the general level of interest rates, already discussed in Chapter X, and the degree of confidence felt by the security-buying public, generally reflected in a willingness to buy freely. The following diagram summarizes the distribution of risks in the security markets:



The market for securities is thus seen to be a highly uncertain affair, involving not only the ordinary risks of business, but a number of additional factors arising out of the market itself. These risks are to some extent segregated by the process of issuing prior securities or trading on the equity, and they are reduced or increased, as the case may be, by the financial policies followed by individual corporations.

Speculation and the Security Markets

We have thus far considered speculation as an individual activity, consisting of the assumption of risks for the sake of profit. We now wish to determine the effects of such speculative activity on security prices, especially in the organized security markets.

The only way in which speculation affects the security market as a whole is in the extent to which it results in purchases and sales of securities over and above what would be the case if speculative activity were non-existent. The purchaser of speculative securities who buys them outright and holds them for profit is an investor from the standpoint of the market—he makes his purchase and pays for it just as he would for a high-grade investment issue. We often read of "investment buying" going on in the stock market. This refers to purchases of all kinds of securities, regardless of the risk involved, by those who mean to pay for them and retain them for some period of time.

Only that kind of speculation affects the market in a special way which creates a demand for securities over and above such "investment buying." Such a demand is created when securities are bought on margin, for in this way an individual uses bank credit to buy more securities than he can afford to control with his own funds. Such purchases are seldom designed as permanent commitments. Rather it is hoped that the price of the security will rise within the shortest possible period, and that after it has risen the speculator will be able to resell to someone else, either another speculator or an investor, who will pay for and hold it more or less permanently. Secondly, those who buy and sell large amounts of securities with their own funds for the sake of quick profits exercise a distinct effect on the level of prices, especially when such trading is designed to bring about substantial price change, as in pool manipulation. In this class are also floor traders and other professional buyers and sellers of securities, who often buy and sell on the same day and thus avoid the necessity of paying for their purchases. In the third place, short sellers of securities, by increasing the supply, affect the market in a special way.

The effects of large-scale speculation upon the course of security prices have often been discussed in the past. The optimistic view of such effects, frequently presented at some length by apologists for speculative activity who feel called upon to answer ignorant popular criticism of the stock exchanges, holds that the speculator limits price fluctuations, and thus benefits the public. Stability of security prices is obviously desirable from the investment and social viewpoint. The speculator, through buying when investment demand is small for one reason or another, keeps prices from falling, or at any rate from falling too rapidly. He is willing to utilize bank credit and assume the risk of carrying securities for the sake of a gain he is said to earn abundantly in terms of social service. Similarly, the short seller is found to exercise a beneficent influence in maintaining the relative stability of prices. When prices go up too fast, it is argued, the short sales of the speculator limit the rise. Conversely, when prices decline too rapidly, covering operations by short sellers similarly limit the amplitude of the fluctuations.

This optimistic view is based on an assumption very common to classical economics, which explains why one of the best-known expositions of it has come from the pen of John Stuart Mill. It assumes that the speculator is an entirely rational and farsighted, as well as successful, being. This assumption perhaps is largely borne out in a few cases, but there are many instances when the contrary has proved to be the case.

There is a strong psychological attraction in the assumption of risks which few individuals escape. Usually, this tendency is gratified in purely gambling activities of a minor sort, such as card playing, sports, etc. However, what financial writers are pleased to term "the public" is now ever ready to gratify this tendency in the stock market also if prices rise steadily; and the history of stock speculation is replete with such periods of widespread public participation in the stock market, during which reasoned analysis of values becomes a poor guide to price movements, and even the able and shrewd professional speculator must throw caution to the winds and swim with the tide if he is to escape being swept away. Speculation at such periods doubtless greatly increases the amplitude of price fluctuations, instead of making for price stability.

When we consider, not the broad movements of the market, but changes in individual securities, speculation doubtless plays a much larger rôle in increasing the amplitude of fluctuations. Frequently a stock declines in price after a major upswing, on the announcement of the news that the upswing had anticipated. The speculator explains the drop by the fact that "the news is out." What he means is that speculation had more than anticipated the rise. But the tendency of speculation to exaggerate price movements is even greater when popular attention is attracted to one particular security or group of securities by some rumor or report, the exact import of which is not correctly gauged. Fig. 9 shows the movement in the price of American Telephone & Telegraph capital stock, from January 1, 1927, to May 3, 1929, when no significant news was published about the company, but speculation was rampant in the security market generally. While a free market may stabilize prices in general, and over a period of time, it does cause wide discrepancies in the cases of individual issues.

There is no need to defend speculation on moral or ethical grounds by alleging that it limits security price fluctuations. The fact is that, without a free market for such speculative securities, it would not be possible freely to secure capital for new and uncertain enterprises. Numerous sound investment securities of the present day passed through a long period in which they underwent wild and exaggerated fluctuations because of keen speculation in their shares. It was chiefly the appeal of these speculative movements to the stock trader which made it possible to float these shares in the first place, however.

Speculation as such is neither more nor less desirable than investment, from the social standpoint, as has been seen.

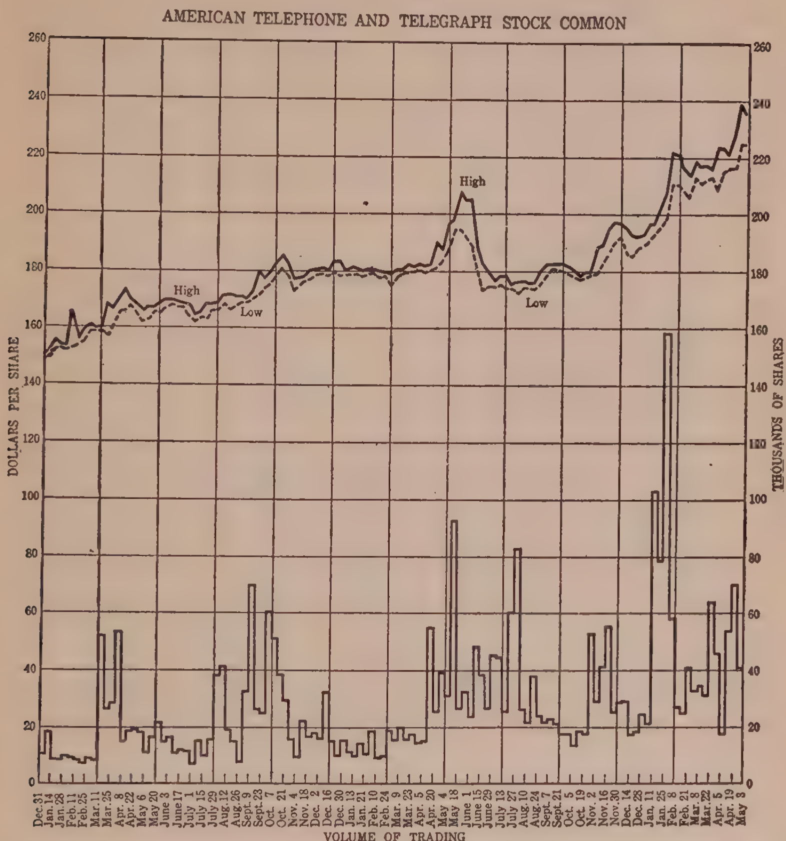


FIG. 9. Weekly High and Low Prices for American Telephone & Telegraph Capital Stock on the New York Stock Exchange, with Volume of Trading. January 1, 1927—May 3, 1929.

Economic and Social Effects of Security Speculation

The chief general economic effects of security speculation as now carried on are three in number. These are:

1. Capital is made available for almost any new enterprise which promises large returns through the development of a demand for speculative securities.

The automobile, the radio and the airplane industries have within recent decades proved that substantial amounts of capital can be raised within this country when the industry for which capital is sought is hardly out of its embryonic stage, and the reasons why are clearly set forth in the average prospectus advertising a new security offering of this type. The writer of such a prospectus can point to similar success of other new industries in the past, and the number of such cases has been legion. An argument by analogy may not always be sound, but it is invariably effective, especially in a new and ever-growing country.

As a result of the many cases of fabulous profits earned from the purchase of speculative securities, a large part of the security-buying public in this country is hungry for speculative possibilities, even at the expense of stability and safety. National psychology differs greatly in this respect. Just as the average French investor carefully tries to avoid risk, although he does not always succeed, American investors, even of the conservative type, will frequently place their money in a speculative issue "with long-pull possibilities." This tendency has been ever associated with the pioneer spirit.

2. The savings and bank credit resources of the country are opened to the use of enterprises of a speculative nature.

One of the most remarkable aspects of security speculation of the characteristic margin-trading type is that it makes a speculative security purchase the basis of a bank loan generally considered of the most liquid and safe kind. The margin trader, specializing in the assumption of such risks, advances, in the usual case, from 15 to 40 per cent of the market price of the security, the rest being secured from a bank on a collateral loan. This loan, usually of the call type, then is considered the most liquid part of the bank's portfolio, although it is, at the same time, the means which permit the creation of a market for the speculative security in question. A large part of the billions of dollars invested by the banks in call and time security loans, therefore, represents a tapping of the liquid credit resources of the country for the purposes of financing speculative enterprises. The risk element in the transaction is segregated and borne by the speculator, because he is lured by the possibilities of large profits.

3. Speculation acts as a stabilizer, although an imperfect one, in the market for securities.

It has been seen above that frequently, owing to the imperfections of the speculator himself and the alternating ebb and flow of public participation in the market, speculation may exaggerate ordinary fluctuations in security prices. It remains true, however, that the speculator is frequently the only buyer when other holders are eager to sell out their holdings, while conversely he may be a short seller when a temporary heavy demand bids fair to overvalue prices.

The social effects of speculation are more intangible and difficult to measure. Doubtless there have been numerous occasions—the more picturesque of which have been the tulip craze in Holland and the South Sea bubble in England—when popular participation in speculation became so keen that the ordinary life of the community was disrupted and a part of the populace demoralized by the get-rich-quick idea. On the other hand, speculation has proved for some an avenue to that more highly regarded habit known as thrift. The meager return of the pure investment security may not be able to lure into the fold of investors those of a more speculative temperament; but the combination of investment and speculative features held out by many securities now traded in on the market does have the effect of breaking them into the security-buying habit.

Speculation and Bank Credit

The bulk of security speculation takes place with the use of bank credit, secured either through brokers' loans or through direct loans to speculators from their banks, the securities bought being used as collateral. The volume of bank credit absorbed in such speculative purchases of securities varies widely with the state of the security markets. Early in 1929, the banks of this country had in round numbers $3,000,000,000 of brokers' loans outstanding, and $10,000,000,000 of loans made to other borrowers secured by stocks and bonds. While a large part of this latter sum represented loans made for commercial and industrial purposes, perhaps the bulk of these security loans at that particular time represented the use of bank credit in the carrying of securities for a rise.

When the volume of bank credit absorbed in security speculation expands, as it did rapidly in 1927, 1928 and 1929, a serious question arises in connection with the effect of this speculative expansion upon the general banking structure of the country and the condition of business. Does this speculative credit expansion make much less credit available for business needs? What happens to the credit thus advanced to speculators?

The superficial view frequently advanced is that the security markets absorb credit like a sponge, so that the more credit there is outstanding against securities, the less there is left for the agricultural, commercial and industrial borrowers who wish funds for "legitimate" business use. But if this problem is analyzed, it is found that practically all of the bank credit which originally takes the form of a loan to a broker or a security speculator goes into business as purchasing power either in the hands of business corporations or in the hands of buyers of securities.

To prove this thesis, it is necessary to trace the course of the credit which originates as a loan for the purpose of carrying securities. The buyer of securities, or his broker, uses the bank credit to help pay for the securities. The seller of the securities who thus receives this buying power may do one of several things. If he buys other outstanding securities, he merely transfers the credit to another seller of securities, and the problem remains in its original form. Sooner or later, however, many sellers buy new issues of securities with the purchasing power so obtained, and thus transfer the proceeds of the broker's loan, at one or more removes, to business corporations and governments which issue securities. In so far as security loans go into new capital issues, directly or indirectly, therefore, they represent credit created in the first instance for speculative purposes, but transferred to business. These security loans permit the sale of new securities in much larger volume than would otherwise be the case, and constitute the means for financing business through the security markets instead of the old-fashioned way through the banks.

But not all those selling securities to buyers who pay with the aid of security loans put the proceeds into other securities. Many individuals put such proceeds directly into business enterprises which they own. Here the broker's loan is used to finance business even more directly. Others put such proceeds into real estate where, once again, the broker's loan is used to finance an important productive industry.

Finally, in times of rising security prices, a large part of the profits made possible by increasing security loans to brokers and individuals goes directly into consumption goods. Fine automobiles, sumptuous residences and other more or less luxurious forms of spending are made possible through sales of securities at large profits—sales made to others who borrow from the bank to pay for their purchases.

Therefore, we may conclude that bank credit finances business, no matter whether advances are made directly to corporations and farmers or indirectly through security loans, the proceeds of which are either used to buy new security issues or are placed by the sellers directly in their businesses, or are spent for consumption goods and thus transferred to the business enterprises selling the goods. As a matter of fact, this illustrates one general truth of banking—that bank credit normally cannot be destroyed, but is merely transferred from one account to another until repaid. The credit which takes the form of a security loan is thus transferred practically entirely to business firms. Roughly, this might be called a case of the law of the conservation of bank credit, corresponding to the laws of the conservation of energy and the conservation of matter in physics.

From the social viewpoint, however, there is a vast difference between credit expansion through security loans and credit expansion through business loans. The latter are made by individual bankers, generally after analysis of the credit of the borrower and some scrutiny of the purpose of the advance. The banker's influence is all on the side of conservatism, liquidity and safety. When business raises money via the security markets, however, the disposition of the credit is largely at the mercy of the security speculator, who picks securities which give immediate indication of appreciation. If the proceeds of the security loans go into consumption, the buyer of luxuries has the control over the flow of credit. Therefore, a large volume of security loans reflects the fact that the investor, the speculator and the spender, in place of the banker, have been made arbiters of the flow of credit.

Manipulation and Security Prices

In the discussion of speculation above, care has been taken to avoid reference to one concomitant of much of organized speculative activity—manipulation. There are those who would say that the stock exchange is merely a den of iniquitous manipulation—a very obvious superficial exaggeration. Equally exaggerated is the claim of those who solemnly state that prices of speculative securities reflect solely "the free play of the forces of supply and demand." It requires a very short acquaintance indeed with the stock market to know that manipulation is a very important factor—one that makes the term "organized speculation" particularly appropriate—in security price movements.

One of those who mistakenly feel called upon to act as the heaven-sent apologists of things as they are has this to say about speculation on the exchanges:[1]

> The most easily manipulated market is the limited market. The market you cannot manipulate is the big, open, easy, facile market, where everybody can trade with the least restriction. . . . There is no man so big he can manipulate a market into which the whole public comes. The idea that a big man can manipulate a market is greatly exaggerated anyway, but the bigger the market the harder it is for the big man to manipulate it. If the market is bigger than the man he cannot manipulate it. The public determines the price of the stock in the long run, and the more easily you let the public come in the harder it is for the big man to manipulate.

This sort of ratiocination is based upon a very superficial view of the nature of the securities markets. There is no one uniform commodity there which the public can come in to buy and sell as the market moves higher and lower. Instead, there is a large number of securities, in each of which a different

[1] Testimony of H. C. Emery in Regulation of the Stock Exchange, Hearings before the Committee on Banking and Currency, U. S. Senate, 63rd Congress, 2nd Session, on s. 3895, Washington, 1914.

technical market situation may occur. In one case, where the ownership of the security is spread widely among the public, it may be difficult to bring about a major fluctuation without public confidence, although a group with the proper financial sponsorship could and constantly does create such confidence by artificial means. As a matter of fact, however, many large and well-distributed stock issues have so small a floating supply as to permit of wide manipulative movements. In other cases, where the stock is largely held by a few individuals with plentiful means, there is no reason why a major movement cannot be brought about without public participation.

Manipulation becomes all the more effective because of the unequal knowledge and financial resources of the several classes of participants in the business of stock speculation. First, there is the "public," consisting mainly of relatively small traders and investors, often with a very imperfect notion of conditions surrounding security values and distinctly limited resources. This public buying does not as a rule suffice to cause wide changes in the price level of securities, for it is not efficiently directed toward an end. When stocks are left alone and the public has the market in its own hands, prices are likely to move uncertainly up and down, without any decisive trend, unless there is special and definite news forthcoming about the issue. The outside public generally must be led and directed in its buying before decisive price trends occur. As a rule, the public buys on a large scale only when there is a sharp rise in prices, or when "tips" to buy are sent out by brokers or through more devious channels. In both cases, it is obvious that others provide the incentive which results in purchasing by the average trader. It is only in the exceptional case that the public "takes the bit in its teeth," and overwhelms the plans of the big interests operating in the market by acting contrary to expectation, through excessive optimism or the reverse. [1]

A second important group of participants in the stock market are the professional traders, who know the ways of the market and make a business of operating on it. These professionals,

[1] The factors in the speculative security market are discussed fully in Bond, Frederic Drew, *Stock Movements and Speculation*, chap. iii.

while armed with much better knowledge and much larger resources than the average outside trader, also follow rather than direct the trend of the market. The average professional speculator is eager to follow the trend once it is established, whether it be for a rise or fall, relying as a rule on others to initiate and direct the movement.

The third factor in the speculative security markets is the operations of the leading financiers and industrialists—people sometimes vaguely termed "insiders." These leaders, with powerful banking connections, and controlling as they do the management of many of the corporations whose shares are traded in on the security markets, are in a position to make the trend in the market, provided they do not flout fundamental economic conditions for any length of time. Within this select group are found the leading bankers of the country, the great investment bankers, a number of heads of stock exchange houses and the executives of sundry corporations.

On the other hand, it must be remembered that the backbone of the market is the buying of investors, who acquire securities to hold rather than to sell out as soon as possible to someone else at a higher price. This investment buying does not exercise much effect on the trend of prices at any one time, for such buying constitutes a relatively small proportion of the total volume of transactions in active stocks. Furthermore, investment buying is accomplished once and for all, while speculative trading results in a heavy turnover of stock again and again. But over a period of time investment buying cuts down the floating supply of a security, the latter connoting the portion registered in the names of brokers and held for speculative appreciation.

Furthermore, in the long run this investment buying and that of the trading public determine to a large extent the selling price of a security. No one cares artificially to maintain the price of a security indefinitely unless the public follows suit and buys it at the higher prices. But a major manipulative operation may be carried on over a period of years, during which the price is kept at an artificial level. If the public does not join in, the price must sooner or later find a level at which those seeking to manipulate can relieve themselves of the holdings bought for this purpose. More usually, the price is raised intermittently and then allowed to drop to permit a repetition of the process.

Effect on Investment Securities

The ebb and flow of speculative and manipulative activity naturally have a considerable effect on the market for investment securities. High-grade common stocks especially are subject to occasional wide fluctuations in response to such activity, impairing their stability and in many cases their worth as pure investment securities. This is especially the case in times of widespread public participation in security speculation, when many conservative issues are taken in hand and whirled up to unjustified heights. At such a time, many arguments may be forthcoming to rationalize what happens, such as the infinite future growth of the country, the change from a debtor to a creditor nation, etc. But the fact remains that even the best securities may rise too high and then constitute a poor investment, just as the poorest securities may be priced too low and then constitute a good speculative commitment.

One result of this speculative activity in investment securities is to create a broad group of speculative investments which involve limited risks, but in which an opportunity for a substantial speculative profit exists. In this group are to be found a large number of high-grade common stocks, and several preferred stocks and bonds selling at low prices. The bulk of the bonds of foreign governments of poor credit standing are doubtless also included in this class.

It would undoubtedly be desirable to avoid fluctuations in investment securities, if this could be done without interfering with the freedom of essential speculative financial operations. Stability is from the long-range point of view a desirable quality in an investment, and in the long run constitutes a great source of encouragement to the accumulation of savings in the community. Through publishing a mass of information on the operations of the railroads, and through rigid control of their financial policies, the Interstate Commerce Commission after 1920 sought in a general way to stabilize the investment value of railroad securities with this in view, and succeeded to a substantial degree. But experience shows that capital can be raised most quickly for any purpose while similar securities are rising sharply. Hence, in a new industry or a new country, highly fluctuating and speculative security markets prove desirable, if the general trend is upward. Then heavy purchases by speculators create an adequate supply of capital where investors would be slow to place their funds.

Reduction of Risk through Financial Organization

In this chapter, the risk element in the business structure as a whole and in the security markets has been analyzed into its component elements. Through expert management and proper diversification of risks, speculative reverses may be largely reduced.

The financial institutions discussed in the first part of this volume are devoted in part to the reduction or isolation of the risk element. The savings bank and investment trust, by careful investigation in purchasing and diversification in holding securities, seek to eliminate it. The general management type of investment trust, as organized in this country, further segregates risk by the process of trading on the equity on its own account. In this way, while the senior securities are high grade, the junior issues represent those with the risk element isolated, and are frequently of a highly speculative nature.

The investment banking house, which acts as the middleman between the issuing corporation and the buyers of securities, plays a rôle in the stabilization of investment. By its investigation and sponsorship, it often eliminates part of the uncertainty surrounding the security. After the issue has been put out, the market is generally supported, at least during the period in which it is being distributed. Finally, many houses seek to establish a market over a longer period of time. By watching over the market, the investment banking house can act in the interest of avoiding major price fluctuations through artificially intervening when this appears necessary, buying of the issue when the supply appears to be too large, and selling back when the market appears able to absorb a large supply. The banking house can thus limit the effect of speculation, if any occurs, upon the price of an issue intended to be an investment security. Of course, when the speculative movement gets under way with force, the banker can do little, although he may try to halt the advance by pointing out, directly or indirectly, that it is unjustified, and presenting the facts to prove this assertion.

Combining Speculation and Investment

While part of the machinery of investment banking and corporation finance seeks to delimit the field of investment from that of speculation, a tendency exists also to combine the two. Many an investor seeks to combine his investment with some speculative feature which will enable him to profit from any unusual prosperity which may befall the enterprise issuing the security. Hence the great vogue of convertible securities, and those with options attached, especially within recent years.

A security of this kind really consists of two portions—an investment bond or preferred stock, and a call on a more or less speculative common stock. This call is generally a highly speculative item with a small immediate value. Nevertheless, so many of these features have proved profitable in the past, over a period of years, that they have a special fascination for even conservative investors. Especially in times of a general rise in the security markets, convertible securities and those with options attached are in great demand. Then even *bona fide* investors demand a speculative "kick" to their securities.

This mixture of investment and speculative features often results in complicating the value of the security to a considerable extent, because of the presence of both features. On the other hand, where an enterprise is not strongly enough established to justify the issue of bonds which can be offered as high-grade investments, this feature proves a convenient means of raising money at relatively low cost. In the case of senior security issues of smaller industrials, the Industrial Securities Committee of the Investment Bankers Association has gone so far as to consider that the investor has some right to such a speculative feature, in view of the risk he necessarily assumes.

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Chapter XII

CONTROL OF INVESTMENT CREDIT AND SECURITY SPECULATION

Need for Investment Credit Control

In the preceding chapters, the flow of funds into the capital market has been considered. The relation of the money to the capital market and the effect of the phenomenon of speculation upon both have also been taken up. The process has been regarded as largely automatic and determined by the institutional environment. Efforts have been made, however, to control the capital market through organized intervention, and it is to these efforts that the present chapter is devoted.

From early days, the need for some agency for controlling banking activity has been felt. This need has grown steadily with the increasing size and complexity of the banking systems of the leading countries of the world. Since, as has been seen, the money and capital markets are closely related in a number of ways, control of commercial banking necessarily implies investment banking control as well.

Control has been found necessary to assure the ultimate soundness and stability of a credit structure, and may be exercised in a variety of ways. The usual method is the establishment of a central bank under government auspices, which then operates not for its own profit primarily, but for the purpose of keeping the credit structure of the country on a sound basis. In modern central banking practice, this has been done through operations in the money market which the central bank, with its great resources, is able to carry out on a scale sufficiently large to affect the entire banking and business structure.

The chief concern of the central banking agencies which, like the Bank of England, the Bank of France and the Federal Reserve Banks, seek to control the credit situation within a country is the money market, the organization of which has been described in Chapter X. They are interested primarily in the market for short-term loans and paper, for they are formed for the purpose of acting as bankers' banks, controlling the volume of credit made available to business and agriculture. Investment banking, or the supplying of long-term capital, does not in the first instance fall within the province of central banking activity, except in so far as the supply of capital to the government is concerned. Invariably, central banks become fiscal agencies of the government, despite many past and present attempts to separate the two.

While in theory most central banks are expected to concern themselves with the money market alone, they inevitably affect the capital market as well, for, as was shown in Chapter X, one of the prime functions exercised by the money market is the regulation of the supply of capital which flows into the securities market and into speculation. Changes in the money market always affect the flow of funds into investment and speculation, and hence the activity of the agency which controls the one will affect the other. Conversely, no agency controlling the money market can afford to close its eyes to the condition of the capital markets. Again and again in the past, excessive activity in the capital market, either through unwarrantedly large new capital issues or widespread speculation in stocks, has tightened the money market and, by creating an unbalanced expansion of bank credit, has compelled corrective measures on the part of the banking authorities.

Besides the control, generally indirect, exercised by the central bank on the capital market, a certain amount is also exercised by the investment banking houses themselves. As yet, no agency resembling a central investment banking institution has been evolved, but several of the largest investment banking houses have, in the leading investment banking centers, developed sufficient contact among themselves and control over other banking institutions to work together to a considerable extent.

Finally, the government exercises some control over investment credit in unusual circumstances, especially in time of war and in connection with the movement of capital between countries.

Types of Control

Control over credit may be essentially either quantitative or qualitative. It may seek to regulate the total volume of credit sought, or determine the type of borrower who shall get the credit available. In central banking practice, both types of control are exercised. Through manipulation of the rediscount rate, through purchases and sales of bankers' acceptances and through similar operations in government securities, the central bank exercises a profound effect on the total volume of liquid funds in the market. At the same time, by favoring agricultural and business paper and seeking to discriminate against paper arising out of speculative transactions, the central banks in some countries, and notably in the United States, endeavor to install a régime of qualitative credit control as well. If this régime works successfully, rates for speculative credit might soar at the same time that the cost of money for purely business and agricultural uses remains unchanged. This policy of qualitative credit control is practicable only if the reserve banks can actually direct the disposition of the credit they grant; and their ability to do so is a moot question.[1]

As investment credit control is largely indirect, arising through control of the money market, qualitative control of it is particularly difficult. Hence, when it becomes necessary owing to special circumstances, the government usually intervenes, as it did during the war when the Capital Issues Committee was established to give financing of war needs priority over other capital flotations.

Control of the capital market on a qualitative basis through discrimination between investment and speculative activity has been attempted in the past. Federal Reserve authorities have sought to withhold the use of short-term funds for the purpose of carrying stocks for a rise in price, especially in the form of brokers' loans. At the same time, they have expressed themselves as unwilling to interfere with the flow of credit into industry through the issuance and sale of investment securities.

[1] This is the expressed aim of the Federal Reserve Act. Some writers deny that this policy can be enforced. Thus Burgess says, "The Reserve System cannot prescribe the uses to which credit shall be put. That decision rests with the individual member bank." See Burgess, W. R., *The Reserve Banks and the Money Market*, p. 179.

A qualitative distinction between investment and speculative security loans is extremely difficult to make because of the impossibility of distinguishing between these two types of transactions from the point of view of the capital market as a whole, as was seen in the preceding chapter. It was there concluded that the major distinction from the market viewpoint is the extent to which bank credit is absorbed to carry securities, regardless of the amount of risk involved in the securities purchased and whether new or old issues are involved. In fact, loans made to speculative security buyers to permit them to purchase stocks on margin are used to a large extent to pay for securities bought from those who desire to place the proceeds in new security offerings.

However, as was seen in Part I of this book, investment and speculative activities in the securities markets are carried on to a large extent by different institutions. Efforts to control each, therefore, involve different problems. Accordingly, while the close interconnection of investment and speculative activity in the capital market is recognized, each will be treated separately here.

Control of Investment Credit

The market for investment securities is subject to constantly changing conditions. If the supply of funds seeking permanent investment is large, and the demand for capital, as reflected by the volume of new security offerings, is small, bond prices tend to rise. This rise in prices encourages investors to hasten their purchases, and a certain amount of speculative buying for the rise enters the market to expand further its power to absorb new securities. On the other hand, declining bond prices, from whatever cause, discourage buyers and thus tend to slow up the flow of investment capital, and at times to halt it practically entirely.

Any tightening of the money market will affect the capital market only in so far as it increases the supply of investment securities in the market and thus adversely affects the price level. Let us assume, for example, that, as a result of rapidly expanding business activity and a resulting expansion of commercial credit, money rates rise, and the central bank seeks to prevent further expansion by raising its rediscount rate and selling in the open market bankers' acceptances and government securities. The immediate effect is to increase the supply of bonds in the market from several sources. Commercial banks are large holders of bonds. On June 30, 1928, all banks were reported officially to hold, in round numbers, $6,000,000,000 of government bonds and $12,000,000,000 of other securities, mainly corporate bonds. The commercial banks hold these securities in their portfolios only so long as they give a larger return than can be secured from other sources, liquidity and marketability being considered. When higher rates are available elsewhere, and especially when they need funds because of a tightening of the money market by the action of the reserve banks, the commercial banks sell securities if they can do so without too great price depreciation. This increases the supply of bonds in the market, and has an adverse effect on their prices.

There is a second way in which the tightening of money rates adversely affects prices for long-term bonds. As was seen in Chapter II, investment banking houses carry new issues of securities, pending their distribution to investors, on collateral loan with commercial banks. When money rates are high, it becomes expensive to carry securities in this way, as the interest received on them does not, in many cases, cover the interest paid the banks on the collateral loans. The result is that bond houses become eager to dispose of the bonds more quickly, often at some slight sacrifice in price. Furthermore, the expense of carrying new offerings will in itself make bond houses less eager to buy other new issues unless it can buy them cheaply, price them below the market level, and thus sell them quickly. This tends to lower bond prices generally.

In the third place, higher money rates will cause certain investors to shift from the capital to the money markets because of the higher return obtainable in the latter. Thus, in the latter part of 1928, when call money rates frequently ruled above 7 per cent, many institutional and individual investors sold bonds giving returns in many instances of 5 per cent or less, and instead put out the proceeds in the call market. Thus, the supply of bonds in the market was increased and prices dropped. This process was greatly extended during the following year, when the call money rate reached 20 per cent.

Conversely, low money rates tend to expand the demand for investment securities from banks and investors, and to encourage investment banking houses to put out new issues which can be carried cheaply at the banks. When money rates are tending downward, furthermore, individual and institutional buying is hastened.

As a rule, the volume of new security offerings reflects the state of the bond market more than any other factor. In other words, the effective demand for new capital is largely a function of the condition of its supply. When the market is in good shape, investment bankers hasten to put out issues which they have been working on for some time, and borrowers are tempted in turn to enter the market by declining rates. On the other hand, adverse conditions in the market cause investment bankers to discourage would-be borrowers from entering the market, and to hold up as long as possible issues which they do take on. Therefore, when a rise of substantial proportions in money rates takes place, resulting in depressed conditions in the bond market, there is an immediate tendency for the supply of new issues to decline and for the flow of funds into investment channels to be reduced. The effects of a failure to follow such a policy are discussed in the section following this.

High money rates, therefore, tend to cause a condition of indigestion in the bond market. The market being over-supplied with bonds, investment banking houses accumulate large volumes of bonds of both old and new issues, which they find they cannot sell rapidly enough. The accumulation of unsold securities discourages new issues and interferes with the regular functioning of the investment banking mechanism. At such times in the past it has been estimated that unsold securities "on the shelves" of bond houses and dealers may rise to more than $1,000,000,000.

The manner in which the rise in money rates affected bond prices and the volume of new security issues during 1928 is shown in the following table:

Month	Average call money rate (per cent)	Mean of bond prices (per cent)	Volume of new bond offerings
January	4.26	93.05	$598,198,937
February	4.36	92.66	645,931,500
March	4.47	92.50	569,624,208
April	5.03	93.31	726,881,350
May	5.68	92.67	630,612,825
June	6.17	91.25	582,846,017
July	6.66	90.46	192,932,841
August	6.77	89.72	126,430,040
September	7.25	90.58	309,872,450
October	6.94	90.68	355,279,000
November	6.75	90.96	429.745,000
December	8.74	90.23	302,040,200

Control of the supply of investment capital which central banking authorities can exercise through their jurisdiction over the money market is further limited during periods of large-scale security speculation by the ability of corporations to sell more or less speculative stocks instead of bonds or preferred stock of investment character. At such times, although money rates may rise to high levels and bond prices be much depressed, the public appetite for securities with possibilities of appreciation may be so keen as to permit the volume of new security issues to remain large. This is illustrated by the experience of 1928 and 1929. The following table shows how a rising call money rate was accompanied by a sharp increase in the relative proportion of stock financing in the market. The tendency was further accentuated by the large number of bonds with speculative conversion and option warrant features which were sold largely on the basis of the latter, rather than on any intrinsic investment merit.

During the five years preceding July, 1928, when stock financing first became a pronounced feature of the capital market, new stock flotations amounted to approximately 25 per cent of the total volume of new issues of all kinds.

Month	Average call money rate (per cent)	Total new financing (in millions of dollars)	Per cent in stock issues
July, 1928	6.66	625	69
August	6.77	274	54
September	7.25	476	40
October	6.94	783	55
November	6.75	875	50
December	8.74	986	60
January, 1929	7.07	703	51
February	6.98	1,021	59
March	9.52	1,050	50
April	8.75	618	53
May	8.70	634	59
June	7.60	813	65

Control by Investment Houses

A state of indigestion in the bond market can also be brought about through failure of issue houses to keep down the volume of new offerings to a figure which the market can absorb, regardless of what the relative size of the demand may happen to be. No matter whether the demand be small or large, if the stream of new offerings is excessive in relation to that demand, the market will soon be burdened by an excess supply of investment securities, bringing about a general decline in prices.

Such a condition developed, for example, in the summer of 1927, at a time when the money market was abnormally low as a result of the efforts of the reserve banks to aid European financial rehabilitation by encouraging the flow of funds abroad. The bond market was in good condition, but investment banking houses sought to take excessive advantage of it by putting out too many individual issues, many too highly priced. Before long they found themselves in the position of being unable to distribute them to investors, and they were left "holding the bag." In order to cut down the rapidly accumulating stocks of unsold bonds, they had to offer them below the original price. When they had cut the price of the new issues and sharply reduced the volume of new offerings for about three months, the market quickly corrected itself and large-scale financing was resumed on a sound basis.

At such periods of congestion brought about by unintelligent multiplication of offerings, the need for some coöperative action by investment banking houses is keenly felt. As a result of experience in such periods, informal efforts to time new offerings so that they will not interfere with one another are frequently made. The leading bond houses are usually informed several days in advance of what each plans to do in the way of new financing, and in self-protection they seek to avoid having too many big issues come out at once. Furthermore, when the market appears top-heavy, many houses will get into closer touch with each other and agree to hold back certain financing until the market improves.

Proposals have been put forward from time to time for a "stagger plan" for new bond offerings, which would permit timing of new offerings in an effective fashion, thus giving the investment houses themselves control over the supply of new securities, and therefore, to some extent, over the volume of investment credit currently made available. These plans, however, have never had a real test.

A measure of control over the process of new financing is also gained through the close relations which subsist between many investment houses and banks. Several large houses of issue, such as J. P. Morgan & Company and Kuhn, Loeb & Company, have an important voice in the management of a number of other security houses and banks in which they are directly or indirectly interested. They can thus dictate to some extent what these other institutions shall do, and use their influence to prevent too large a flow of new issues at any one time. They can also assure that on new security issues, pending distribution, a plentiful supply of bank credit on reasonable conditions shall be made available to themselves and their affiliations.

Government Control

Efforts to control the volume of investment credit sought by issuers of securities through governmental agencies have taken place only during war time. The aim of the government in such times is to mobilize the financial resources of the country for war purposes, and all available funds in the market must be diverted into government bonds to assure an adequate supply of purchasing power for the government. Hence, except in so far as capital issues are made for the benefit of allies or are to foster war industries, they are distinctly discouraged.[1]

Government control, as described above, is qualitative as well as quantitative. During the Great War, the authorities in Washington sought to keep down the volume of investment credit obtained by industry in general, and also to distinguish between demands for capital on a qualitative basis, favoring some and forbidding others, according to whether the industry produced goods or services needed in the war.

In normal times, there is in practically every important country an effort to exercise qualitative control over investment credit in one field—that of foreign investment. In the United States, the government has assumed such qualitative control since the rise of the New York market as an international financing center of the first importance after the war. At a conference in 1921 between leading investment bankers and several cabinet members, the former agreed to keep the State Department informed of such issues. In 1922, the government issued a statement in which it said: "The Department of State cannot of course require American bankers to consult it. . . . The Department believes that in view of the possible national interests involved, it should have the opportunity of saying to the underwriters concerned, should it appear advisable to do so, that there is or is not objection to any particular issue."

Under this policy, the government has prevented the issue of securities of nations which have not arranged to pay their debts to this government, and also of those governments which have not been recognized by our own. In other individual cases, as in the instances of the São Paulo coffee stabilization loan and the German potash loan, the State Department took the initiative in discouraging foreign loans because they were intended to keep up the price of commodities used by the American consumer. Otherwise, our government has avoided

[1] This was the aim of the so-called Capital Issues Committee in Washington during the World War.

interference in the export of American capital abroad. Other nations, like France and Germany, have endeavored to regulate the export of capital in the interests of the political and economic aggrandizement of the nation as a whole. In the case of Germany, the government has interfered also in the import of capital since 1924 by establishing a central bureau designed to approve before issuance all government and municipal loans proposed.

Control of Speculation

The problem of control of investment credit is inseparably connected with the control of speculation in already outstanding securities, especially on the exchanges. Speculation, if carried on moderately, may improve the market for new bond issues through increasing buying power in the hands of security buyers. When extensive enough, it often results in a sharp decline in the demand for bonds and a general rush to buy speculative securities, above all, common stocks. In times of overextended speculation, investment banking houses seek to meet the desires of the buying public by including a larger proportion of speculative securities in their offerings, and thus may greatly expand the aggregate ability of the capital market to absorb new security offerings.

The type of speculative activity in securities which affects the capital market is carried on with the aid of bank credit. Securities bought with bank credit are held for the most part on margin with brokers; to a lesser extent they are bought outright and then carried with the aid of bank loans. Hence, the connection between the volume of security speculation and the money market is far more direct than is the case with the volume of investment credit. Security speculation absorbs directly credit which appears on the books of the commercial banks as collateral loans. Hence, any policy of control which leads to curtailment of such loans should result in a puncturing of the inflated balloon of speculation by taking away or making available only at prohibitive cost the credit basis of the buying movement—the supply of bank loans for carrying purchases of securities.

Before the establishment of the reserve system, there were recurrent periods of speculation which ended abruptly through a severe stringency in the money markets, the sky-rocketing of money rates to such figures as 148 per cent, and simultaneous commercial catastrophe and disorganization resulting from the lack of credit facilities to finance ordinary business needs. The reserve system was planned to obviate these old-fashioned panics by permitting the banks at such times to transfer their best assets to the reserve institutions, thus getting into a position where they could make additional advances of credit without forcing rates up to ruinous levels. At the same time, through its control of the money market, the reserve system was so placed that it could exercise control over the volume of speculation. The law was designed to serve only the "legitimate" needs of business and agriculture, and it specifically states that no paper "covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds or other investment securities, except bonds and notes of the government of the United States" shall have the privilege of rediscount. The fact is, however, that if the banks desire additional credit to finance speculation, they can get it by turning over their commercial paper and acceptances to the reserve banks and using the credit so obtained for speculative purposes, if the Reserve authorities do not object.

Reserve Banks and Speculation

The reserve banks can supply credit to the market in several ways. In the first place, they can rediscount eligible paper of member banks; and, as a matter of fact, most rediscounts consist of notes of member banks secured by government securities. Thus the reserve banks may be used as a source of credit by any member bank having government securities in its portfolio. By manipulating the rediscount rate, some control over the volume of rediscounts may be exercised, although experience shows that higher rates do not always in themselves halt an expansion in credit. In fact, in times of rising security or commodity prices, the demand for credit may increase in the face of a perpendicular rise in interest rates. Secondly, the reserve banks buy bankers' acceptances in the open market, taking all those offered which meet its requirements at a fixed buying rate. In the third place, the reserve banks buy government securities, adding to or subtracting from their holdings of these as they see fit.

But it must be clearly kept in mind that credit provided by the reserve banks through these operations is entirely different from credit provided by member banks. Reserve bank credit permits member banks to increase their reserves by equivalent amount. When a member bank rediscounts $1,000,000 of its obligations, secured by government paper, it gets a credit balance on the books of its reserve banks of that amount. This credit is utilized as soon as possible by making a loan for an amount roughly equivalent. The proceeds of the loan so made are largely withdrawn by the borrower and paid over to his creditors, who deposit the sums so received in their respective banks. The $1,000,000 of reserve credit is thus transferred in large part to other banks. Those who receive these sums in turn pay them out to their creditors. Each bank receiving these deposits gets part of the reserve credit originated by the $1,000,000 rediscount, and uses it as a basis for loans, so that eventually the $1,000,000 of new bank reserve permits an expansion of several times that amount in the banking system as a whole. The latest data available on the reserve system show that this expansion may take place to an amount equal to about eleven times the credit originally given by the reserve bank.

This fact is of great significance for the speculative markets. Let us say that the member banks wish to increase loans by $1,000,000,000 for the purpose of carrying securities. How can they finance such a huge expansion in brokers' loans? Merely by taking something less than $100,000,000 of government securities from their portfolios and using this as collateral to rediscount their notes of that amount with the reserve banks. Such a rise in rediscounts is so small as to make little difference in the position of the reserve system. The same effect can be achieved if $100,000,000 of gold is imported into the country and deposited by the member banks with the reserve institutions, or if the reserve banks purchase in the open market $100,000,000 of acceptances or government securities. In any case, the final result is a credit for that amount on the books of the reserve banks, leading to a multiple credit expansion.

Conversely, should reserve bank policy or an export of gold sharply cut down the volume of reserve credit, the resulting contraction has severe results in the money market. In fact, the contraction, if carried far, is so severe as to threaten disaster. But any movement to restrict credits on the part of the reserve banks tends in the first instance to cause a rapid increase in the volume of rediscounts, regardless of the rate of rediscount fixed. Then the real problem arises of reducing the volume of rediscounts. This was accomplished after the panic of 1920 by enormous gold imports, which were used in large part to repay borrowings at the reserve banks.

It is evident, therefore, that the reserve banks possess the power, through the rediscount rate and open market operations, to control the volume of funds which can be made available by the member banks for speculation. In foreign central banking practice, the discount policy is largely determined by the movement of gold into or out of the country. The business or speculative situation is supposed to affect this policy only when it results in changes in gold holdings, and both business and speculative or "Lombard" paper is accepted for discount. Thus heavy speculation, by raising security prices, may bring a great influx of foreign selling orders, causing an efflux of capital and hence, of gold, from the country. This in turn brings the protective action of a rise in the discount rate, which in turn raises money rates at home and so tends to discourage speculation.[1]

Efforts at Qualitative Credit Control

In the United States, the reserve banks do not seem to have arrived at any definite policy on the rôle they are to play in the future control of speculation. The ordinary functioning of these banks results in a quantitative control of the volume of bank credit. The law seeks to make this control qualitative as well, by ruling out speculative paper from its portfolio; but we have seen that this is not effective in practice, since the reserve banks freely rediscount notes secured by govern-

[1] This technique fails when foreign selling is a small factor, as in the United States. Here speculation brings high money rates, which are followed by an inflow of foreign funds and hence gold imports, instead of exports, as happened in 1928-1929.

ment securities, and since eligible paper may be rediscounted to permit a bank to expand speculative loans. Hence, the question of whether or not qualitative control of credit shall be sought by direct measures by the reserve banks must be decided by them, and ultimately by the Reserve Board.

Attempts to apply such a qualitative control to the money market for the purpose of curtailing speculation first took the form of differential rates of rediscount, placing higher rates on paper presumed to represent funds going into less liquid uses. However, in the post-war period a single rate of rediscount in each district was established, and this has since been the practice.

The question of control of speculation by the reserve banks became acute in 1928, when extensive public participation in stock speculation at rapidly rising prices caused an unprecedented increase in brokers' loans. At the same time, an extensive export of gold amounting in all to approximately half a billion dollars seemed to call for a sharp curtailment in the total volume of outstanding bank credit. Instead, the export of gold and the growing volume of speculative credit were both offset by a sharp rise in rediscounts. The reserve banks were thus called upon to finance a credit expansion at the very time that a contraction was the logical development.

The reserve banks at first resorted to the conventional steps to halt the credit expansion. They sold nearly $500,000,000 of securities, largely for the purpose of further tightening credit conditions and so discouraging expansion. The sale of securities, and the subsequent rise in rediscount rates in most reserve banks from 3½ to 5 per cent, finally appeared to take effect, especially since the reserve banks combined their action with several pronouncements to the effect that speculative curtailment was necessary. For two months, the volume of brokers' loans declined and the volume of trading in the stock market fell off sharply. But intensive speculative activity was resumed in the fall on a more violent scale than before, and simultaneously the reserve banks ceased fighting the expansion of credit for fear of disturbing the seasonal expansion in business. Instead, they bought liberally of acceptances, not raising the buying rate when the volume of bills held by them rose to unprecedented levels. Only in the spring of the following year was the policy of restriction resumed with renewed vigor through sales of government security and acceptance

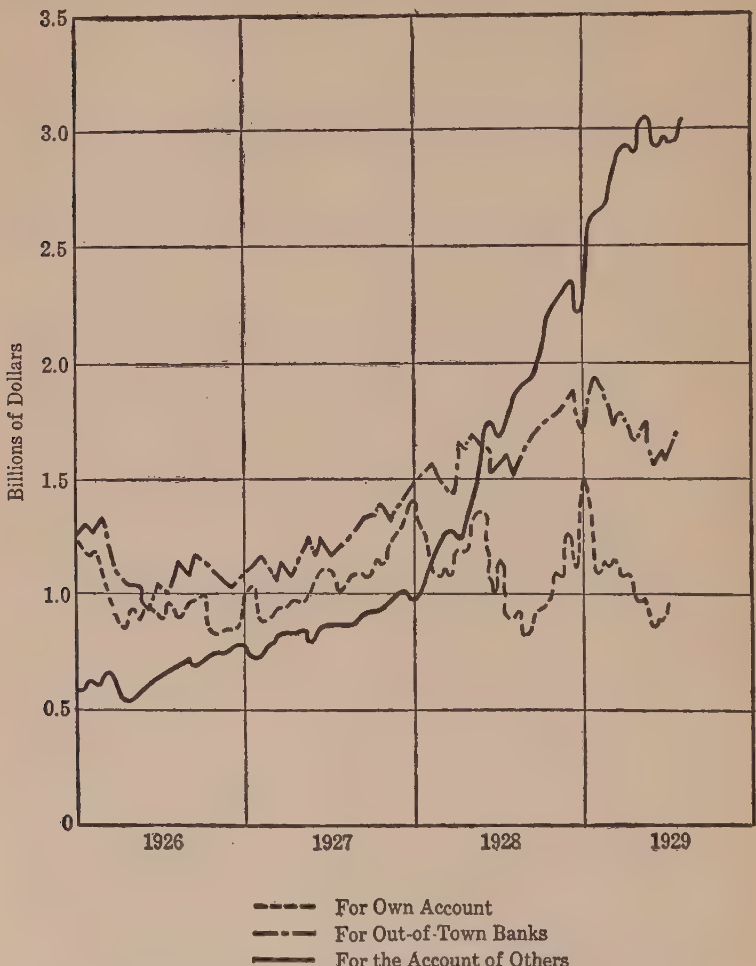

FIG. 10. Sources of Brokers' Loans, January, 1926, to July, 1929. Statistics Published by the Federal Reserve Bank of New York.

holdings. However, sales of these holdings failed to bring the desired results, and by August, 1929, we find a return to the "traditional policy of free purchase of acceptances."

Loans for the Account of Others

The problem of controlling speculation has turned out to be far more difficult than had at first been supposed. When the reserve banks sought to curtail speculation in the spring of 1928, the New York member banks were induced to reduce their loans to brokers sharply, as the reserve banks clearly indicated that they frowned upon the banks' rediscounting for the purpose of making speculative loans. As they could not reduce their rediscounts, they sought peace with the reserve bank by cutting their loans to brokers by about 35 per cent within a few months.

The rate on call money rose perpendicularly in response to these withdrawals. But the expected result of reducing the total was not accomplished. Instead, large amounts of credit were made available to the stock market from non-banking sources. The great New York banks, for a small charge, stand ready to place in the collateral loan market sums of $100,000 or multiples thereof. These loans are listed in their statement to the reserve bank as placed "for the account of others." The chart on the preceding page shows the variation of loans by New York reporting member banks for their own account, for that of out-of-town banks and for the account of others from January, 1926, to July, 1929.

Any effective control of speculation, therefore, must take into account the loans made for the account of others. These come from many sources—from large corporations with large surplus cash accounts; from wealthy individuals who prefer to get a high rate of return on call loans rather than to buy less liquid and low-yielding gilt-edge bonds; from private banking houses and savings banks who are attracted by the high rates; from investment trusts keeping their funds in this liquid shape pending favorable buying opportunities in the securities markets. Doubtless, a substantial portion of these loans comes directly or indirectly from bank loans, certain borrowers finding it possible to borrow at a rate lower than the call rate, and making a profit on the differential.

To control these loans for the account of others is a relatively difficult matter, as the reserve banks appear to have no means of reaching those who make these loans. If they tried to induce member banks to control them or reduce their amount, these loans could be made just as well through money brokers and other non-banking intermediaries, who would thus get the business at the expense of the commercial banks.

Control by Member Banks and Brokers

The control of speculation by the reserve banks may be possible, but it has never been consistently sought. In any case, the coöperation of member banks is practically indispensable if such a policy is to be fully successful. Member banks, by exercising care in their loan policy and scanning individual applications for credit to distinguish speculative from other loans, can go far in reducing the volume of security loans when that appears desirable. Because of the direct contact between borrower and lender, member banks are in the best position to make qualitative credit control possible, although, as has been seen above, their power is limited.

Until the present, such efforts of member banks have been restricted to a large extent to reducing the percentage they care to loan on collateral. Thus, when security prices are rising rapidly and member banks adopt a cautious policy, they will lend 60 per cent of the market value on collateral which normally enjoys loans up to 80 per cent. This is usually accomplished by marking down market values in making loans. Thus, a speculative issue selling at 260 may be considered to have a value of 200 for collateral loan purposes, and the usual percentage is loaned only on the latter amount.

Such a policy of caution on the part of the bank is generally accompanied by similar action by brokerage houses. A brokerage house does not take the lead in cutting down the volume of speculation. Instead, it is among the chief agencies promoting it, and no serious suggestion has yet been put forth that brokers be called upon to control speculation themselves. However, in self-protection, and because of the policy of banks described in the preceding paragraph, brokers do raise margin requirements in times of extended speculation, and thus tend to exercise some restraining influence.

Normal margin requirements of brokers have run between 20 and 30 per cent of the market value for most accounts.

These requirements were increased to 40 per cent by a number of houses during the bull market of 1928-1929, and a long list of speculative leaders, subject to particularly wide fluctuations, were carried only on a margin of 50 per cent, and more. Furthermore, curb stocks and unlisted issues were no longer carried on margin by most houses. Although designed solely as a measure of safety, this also resulted in cutting down the possible maximum purchases which individual speculators could make.

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Chapter XIII

STOCKS *vs.* BONDS

Types of Securities

Modern finance has evolved two radically different types of securities to represent control over capital. The older form is the promise to repay a fixed sum, with periodic interest payments, and is typified by the bond. A relatively newer form of security, which, with the growth of corporate enterprise, has become of the first importance, is the share of stock, which represents direct ownership of a fractional equity in a business enterprise.

These two great types of securities—bonds or evidences of debt, and stocks or evidences of proprietorship—have undergone numerous variations as the complexity of modern business and the capital market have created new needs and new economic situations. The great bulk of securities have to be sold at one time or another, creating a merchandising problem which has a great influence on the form of security adopted. Governments, corporations and bankers are all interested in reducing "sales resistance" in the distribution of their securities to investors to a minimum; and as a result, they are usually quite ready to alter the form of the security if this will mean lower selling costs and a smaller promised return to the buyer. Hence the numerous variations which have been played in modern finance on the two major themes of stocks and bonds.

The bond, originally merely an evidence of an obligation to pay a sum of money and interest for its use, has developed a number of special features. First, it has been given a lien on specific property in many cases, in order to enhance its superior claim to the assets of the obligor in event of default as against other claimants. This creates the mortgage bond. Secondly, numerous instances arose where the bond was made more attractive through the granting of conversion privileges into stock or rights to buy stock at certain specified prices. Here the aim was to give to the bondholder certain of the advantages possessed by the holders of the equity in the property, the stockholders. Other less important features, such as assumption of taxes by the issuer, participating features, etc., have been added to the original simple bond in many instances to make it more attractive.

On the other hand, shares of ownership have been differentiated into preferred and common shares, or into Class A shares and Class B shares, giving a part of the stock capitalization a claim to income superior to that of the rest. The genus preferred stock has been especially subject to mutation, so that it becomes difficult at times to distinguish, except in a formal legal sense, between a specially well-secured preferred stock and a bond.

The legal distinction between the stock and bond—the equity and the debt—has in fact been partially broken down in practice. From the viewpoint of the investor and the corporation, any security with limited income is similar to a bond, in that it does not benefit from excess earning power of the corporation. Owing to the peculiar nature of modern economic organization, a distinction of the greatest importance arises between securities of limited income and those representing equities in properties. Holders of bonds and preferred stocks have claims for the payment to them of a fixed sum in money. Hence, any variation in the purchasing power of money will have a profound effect on the value of their securities as compared with the worth of common stocks, representing ownership of property. The relative position of stocks and bonds as investment media involves a number of complex factors, creating a difficult theoretical problem, the correct understanding of which is of the utmost importance.

Advantages of Bonds

For many years, bonds were regarded as the investment medium *par excellence.* Large institutional investors, such as banks and insurance companies, have been compelled by law to restrict their investments almost entirely to bonds. Trustees have been similarly restricted in most states, except where the deed of trust provided otherwise. What, then, are the advantages of bonds that gave them such a high place in the field of investment?

The first advantage of the bond is its superior position. The bond has a prior claim on the income of the obligor, so that, if anyone is to suffer from reduced earning power, the stockholder first foregoes his income. In the second place, the bondholder's claim to a regular return is a compulsory one, except in the case of the income bond. If earning power disappears temporarily, the bondholder is protected nevertheless, for he has the power to put the corporation into receivership. A third advantage of the bondholder is his prior claim to the assets of the corporation, in case of receivership, so that he can take over control of the entire property and rule out the interests of stockholders if necessary in order to secure his interest and principal.

In point of fact, a corporation issuing bonds strikes a bargain whereby, in return for a prior claim to earnings and assets, money is raised on a promise to pay only a limited return. A fixed rate of income is promised the bondholders; and the directors, acting for the stockholders whom they represent, then strive to earn a larger return on the capital so raised, the income over and above bond interest going to the stockholders.

A final general advantage of well-secured bonds is that they are not heavily bought and sold for speculation as a rule, and are seldom subjected to manipulation in price. As a result, exaggerated price movements are avoided, and a stable market is assured for the investor, should he seek to dispose of his commitment.

The Changing Value of Money

The outcome of this bargain between bondholder and stockholder, whereby bonds are issued with a fixed promise to pay interest periodically and the principal on maturity, is vitally affected by factors not known at the time the bargain is first made. One of the most important of these is a change in the value of money.

The value of money is its purchasing power, as reflected in the level of commodity prices. Since 1790, the price level in the United States, as very roughly measured by available indices, has varied as shown in Fig. 11. In a study of the relative position of stocks and bonds published in 1925, Kenneth S. Van Strum points out a remarkable correspondence between English commodity price movements and changes in the yield on British consols between 1790 and 1923. He concludes from this statistically observed correspondence: [1]

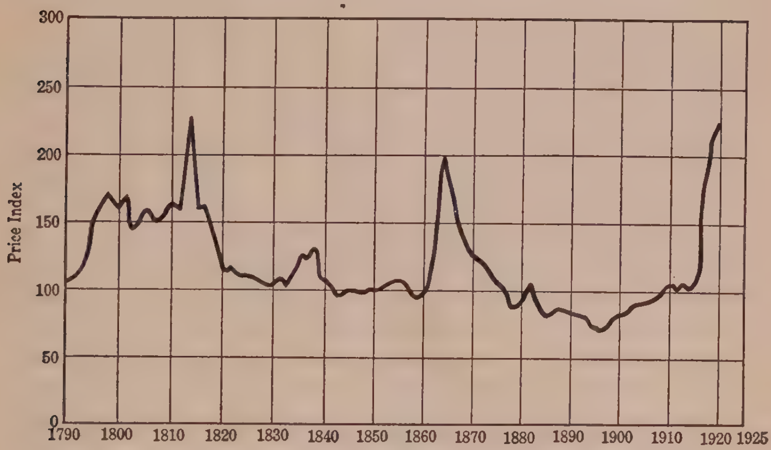

FIG. 11. COMMODITY PRICE INDEX IN THE UNITED STATES, 1790-1925. (1913 = 100.)

> When commodity prices were low the yield on consols was low and when commodity prices were high the yield on consols was high. In other words, the return which the investor in consols demanded for the use of his money was fixed by the purchasing power of money. If the purchasing power of money was low, the yield on consols was high, and if the purchasing power of money was high, the yield on consols was low.

It is evident to the reader of Chapter X that the above statement is superficial and, in the form given, erroneous. Investors do not in practice carefully scrutinize commodity price index numbers before buying bonds, and demand lower prices as the index number rises. They generally pay what they must to get the kind of investment they prefer. If pur-

[1] VAN STRUM, KENNETH S., *Investing in Purchasing Power*, p. 8.

chasing power declines very rapidly they will boycott bond issues, as happened in Germany and France during the period of rapid decline of currency values. But if the movement of prices is very slow, as is the case normally, the psychological attitude of the investor will not be influenced by price movements as such to any significant extent.

On the other hand, rising and falling commodity prices do automatically influence bond prices so that they often move together in the fashion noted by Van Strum in his statistical study. Rising prices mean larger profits, expanding business and a greater demand for capital. This results in bond prices going lower and yields rising. On the other hand, lower commodity prices often bring business depression, a surplus of capital awaiting investment, higher bond prices and lower yields. Sharp changes in the demand for capital because of the changes in business profits, rather than omniscience on the part of capitalists in determining the rate of return they want, cause bond prices usually to follow closely, in their movements, the level of commodity prices. Furthermore, business prosperity influences people to buy stocks because of the larger returns indicated; depression makes them return to bonds for greater security of return and principal.

As a matter of fact, changing commodity prices influence the position of bondholders in two distinct ways. In the first place, they influence the prices of these securities in the manner indicated above, through changing the demand for and supply of capital. Secondly, changes in the price level automatically change the value of dollars which the bondholder receives in payment of the interest and principal of his bond. Let us take the case of the buyer of Atchison, Topeka & Santa Fe general 4's in April, 1902, a time of abnormally high bond prices. It has been pointed out that the bonds at that time could have been obtained at a price of 103½, giving a yield of 3.87 per cent.[1] In July, 1920, when the commodity price level had considerably more than doubled, these bonds had dropped to 71, a decline of 32½ points. But this decline represented only a minor part of the loss incurred. As a matter of fact, the greater real loss resulted from the decline in

[1] Smith, Edgar Lawrence, *Common Stocks as Long-term Investments*, p. 93.

the purchasing power of the dollar to only 37 per cent of what it had been in 1902, so that the buyer of the bond in 1902 had only 25.53 per cent of his original purchasing power left in 1920.

In periods of rising prices, it is doubtless true that the bondholder loses while the stockholder gains. A principal sum invested entirely in bonds will suffer serious diminution through a decline in the market value of the bonds—it will suffer even more perhaps through a decline in the purchasing power of the income received thereon.[1]

The Secular Trend

Another factor strongly affecting the relative position of stocks and bonds is the long-term growth of the country and its great industries—the secular trend in economic life which accompanies a growing population and increasing technical knowledge. The benefits of these developments go to the owners of the individual corporate enterprises which are carrying on the business of the nation. The bondholders with their

[1] The following anecdote related by Van Strum graphically illustrates this point:

"About twenty years ago a certain Boston business man, feeling that he had reached a discreet age for business retirement, sold his business and invested the proceeds in what he considered to be gilt edge bonds. The yield from these securities was ample for his needs and, he thought, would enable him to live for the rest of his life in the style to which he had been accustomed. He maintained a winter residence on dignified Beacon Street, a summer home at the shore and all the accoutrements which accompanied such a standard of living.

"Satisfied that he would be able to continue his old mode of living, he continued his daily life heedless of the encroachment that the rising cost of living was having upon his plans, until one day it was brought forcibly to his attention. He was planning a trip abroad with his family and was surprised to discover that the increased cost of a thousand and one items used in daily life had so eaten into his reserves that it would be necessary for him to draw upon his principal in order to make the trip.

"A few years later he found it necessary to do without several of his servants, some of his club memberships; and one by one he found that there were pleasures which he must forego. By degrees he was forced to curb his standard of living until today the income from his bonds is downright inadequate to assure him the comforts and pleasures he had in the early years of his retirement. But what has happened to his investments? His bonds are as high-grade today as they were twenty years ago and they command the same income in dollars. The answer is to be found in the increased cost of living, and not in the fact that he received any smaller dollar income from his investments."

limited income have no stake in this great forward movement, but shareholders of the successful corporations—and their number has been legion in the course of the phenomenal growth of the country—have reaped a rich harvest.

The advantage of the stockholders in the long run is furthered by the corporate policy of American enterprises. It has long been customary for American corporations to pay out only a portion of their earnings as dividends, retaining the rest in a surplus account from which plant extensions and improvements are financed. The secular upward trend above described provides constant room for this expansion on a profitable basis. As additional sums are profitably invested each year, the value of the equity thus tends to increase at the same rate as a sum of money placed at compound interest, so that Edgar Lawrence Smith concluded that "over a period of years, the principal value of a well-diversified holding of the common stocks of representative corporations, in essential industries, tends to increase in accordance with the operation of compound interest."[1] This increase in value, of course, is in addition to the dividend income yielded by the stocks held. As a result of the widespread growth of corporate surpluses, leading American corporations have for the most part been able to give their stockholders additional benefits in the shape of stock dividends and attractive rights to subscribe to new shares at prices far below their market quotation.

These benefits to stockholders have often been increased, and the bondholders' position made worse, by making bonds callable at the option of the management. When yields fall to a low point and bond prices generally rise, the bonds can be called in and refunded with others bearing a lower coupon rate. This cuts the fixed charges and raises the net income of the company; but it also deprives the bondholder of his investment at a time when bond prices are high and he is at a relative disadvantage in the market in seeking to replace his called security.

The additional benefits of stock dividends and valuable subscription rights, added to the steadily increasing cash dividends paid on the common stocks of most leading corporations over

[1] Smith, *opus cit.*, p. 77.

long periods of years, make the small but steady return on high-grade bonds appear inadequate on the basis of past experience. As Irving Fisher concludes from the available evidence:

> It seems, then, that the market overrates the safety of "safe" securities and pays too much for them, that it underrates the risk of risky securities and pays too little for them, that it pays too much for immediate and too little for remote returns, and, finally, that it mistakes the steadiness of money income from a bond for a steadiness of real income which it does not possess. In steadiness of real income, or purchasing power, a list of diversified common stocks surpasses bonds.

Past Experience and the Future

In this last statement of Professor Fisher's, the experience of the past is tersely summarized. Based on studies carried down to the end of the third decade of the twentieth century, it has been found that stocks were almost consistently undervalued and bonds largely over-valued. The upward movement of prices, the rapid growth of the wealth and enterprise of the country, the attitude of investors—all tended to favor stockholders, and the market seldom appeared to appreciate the fact fully during this period.

But in applying the lessons of the past to the future, it is necessary to exercise caution. It must first be determined whether the experience of the future is likely to be that of the past. Will commodity prices tend upward? About this question there is great difference of opinion among experts. Some point to the increasing efficiency of credit systems, and believe that the tendency to rise displayed by the price level from 1896 to 1913 will be continued. Others point to the efficiency and growing competition in industry, and deduce that prices will tend downward from these causes. And in recent years, this latter viewpoint has received at least partial confirmation from actual developments.

A second question which must be answered is whether the value of corporate equities in the future, as in the past, will tend to increase at a rate similar to a compound interest curve because of reinvested earnings? This question also cannot be answered with the same degree of confidence which would have been possible before the war. Several of our basic industries show signs of over-developed capacity; and since the war, numerous large companies have not found it possible to reinvest their surplus earnings profitably. In fact, this is merely one by-product of the fact that the country as a whole has changed into a creditor nation. We are producing more free capital annually than we can ourselves consume, and many individual corporations find themselves with a surplus of cash on hand which they cannot profitably employ. The result is that numerous American corporations have become practically investment institutions, in addition to carrying on their original specific functions.

In European finance, it is customary for many of the large corporations to pay out their entire earnings, after certain specified reserves, as dividends. In this country, where opportunities for profitably investing additional sums of money annually have been almost universally available, a different corporate policy has been maintained. But in the future it appears likely that an increasing number of American corporations will have to adopt the practice of paying out practically all of their income as dividends. The result will be a less rapid increase in the value of equities; and the compound interest curve may no longer apply to the movement of an average of stock prices, as it did during the first three decades of the century when many of the great American industrial combinations first made their appearance and enjoyed a period of rapid growth.

A third factor which must be kept in mind regarding the relative position of stocks and bonds in the future is the possible change in the accuracy with which investors value the advantage of each type of security. In the past, investors have under-valued stocks. But this error in judgment has been brought forcibly to their attention by such writers as Irving Fisher, Edgar Lawrence Smith and Kenneth S. Van Strum. Numerous holding companies and investment trusts have been formed with this same purpose in mind of enjoying the advantages of stock investment; and the small investor has turned to stocks as an investment medium to an extent never known before. Under the circumstances, it is natural that investors may easily get to over-value stocks, especially if in the future the trend of commodity prices should be downward.

Finally, a number of criticisms may be leveled against the statistical methods followed in such studies as that of Edgar Lawrence Smith, which analyze the past price movements of groups of securities chosen at random, to determine the relative merits of stocks and bonds. These studies, in order to achieve universal application, endeavor to assume a total absence of judgment on the part of the investor. As a matter of fact, it has been the experience of brokers for many years that the average investor or speculator not only shows no judgment, but that he labors under the handicap of a negative quantity of this faculty, which might be termed bad judgment. Not only will he not do what past experience and common sense appear to dictate, but he is likely to do just the opposite.

Furthermore, it is questionable to what extent the tests developed to prove the relative merits of bonds and common stocks really assume a lack of judgment on the part of the investor. In choosing his "diversified list of common stocks," Smith uses a number of methods of sampling designed to eliminate the element of judgment. One of these is choosing the ten most active stocks. In the first place, it is often difficult to tell in advance which are going to be the most active stocks, and hence it is a violent assumption to hold that investors can obtain these shares at their average prices for the period taken, especially during the rising market. In the second place, it is often difficult to secure a diversified list of stocks by taking the most active ones, especially if there is a group movement under way. In the third place, picking the most active stocks in any one week, as Smith does, necessitates trying a number of different weeks through the year as tests of the results from the sample week chosen, which he does not do. Other tests partially overcome these objections, but the fact remains that many investors who have bought common stocks for investment in the past have lost money.

Hence, while the experience of the past warns that the merits of common stocks as investments may easily be under-valued, in the future the investor should ascertain in self-protection that he is not paying too much for an equity which may not prove as profitable as the experience of the past indicates.

The Time Hazard in Stock Purchases

Owing to cyclical movements in stock prices, as well as the influence of speculation as described in Chapter XI, there are times when the general body of stocks is at a level so high that the investor stands to lose a substantial part of his principal by purchasing then. Students of the subject have tended to minimize the dangers of loss at these points, once again on the basis of past experience. Edgar Lawrence Smith, who has already been quoted, in a study of stock prices over the period from 1837 to 1922, found that "in buying a well-diversified group of representative common stocks in essential industries, our chances of coming out even, or of making a profit in principal values, are: Within 1 year, 78 in 100; 2 years, 87 in 100; 4 years, 94 in 100."[1] In other words, there are only six chances in 100 that prices paid today will be as low or lower after four years from now.

This kind of study has but little value as a guide for future action. In the first place, average prices are taken, which will eliminate the greatest bulges. It is true that if stocks are bought at the average prices of the current year, for example, any decline which may take place will probably be regained within a reasonable period of time. It is not as likely that the highest prices of the year will be seen again within the near future, however. In the second place, this study shifts from one group of stocks to another in a way that an investor seldom does. The list is changed three times; in 1880, 1892, and 1901. In the process of industrial change, new concerns come forward and earn large profits, while the old ones decline or move forward at a much slower rate. By shifting from one group to another, it is possible to avoid loss, but this requires considerable vision. Finally, the fundamental fact remains that basic economic conditions have changed to some extent in this country, and therefore conditions surrounding common stock investment in the future may not be as favorable as they have been in the past. As a result, it may be increasingly

[1] Smith, *op. cit.*, p. 82.

difficult for a list of diversified stocks bought at a period of peak prices quickly to regain losses caused by a subsequent decline in the market. The time hazard has become more important.

In the past, the growth of this country and its chief corporations was so phenomenal as to make reckless stock speculation very profitable at times. But this is no reason to believe that the same policy can be followed in the future with impunity, any more than that the primitive but, on the whole, successful farming of the pioneer can still be followed by the farmer today, whose produce competes on the world market with that of cheaper lands elsewhere. The railroads today, under stress of motor vehicle competition and rigid federal regulation, cannot afford to support the reckless expansion and speculative manipulaiton of the old Erie days, when the inevitable rapid growth of traffic could be counted upon to make up in the future for the sins of the present. In the same way, an increasing number of other industries face a slower rate of growth, making the secular increase in equity values much slower and thus increasing the danger that payment of an unwarranted high price for a stock, based on the expectation of a large gain in earnings in the future, may result in the impairment of the capital value of the investment over a period of time.

The reasoning of the whole "common stock school" leads to the conclusion that shares, instead of yielding a return equal to a pure rate of interest plus a premium for risk, as some theorists formerly held, should now yield a current cash return equivalent to a pure interest return less a liberal allowance for benefits expected. Common stocks as a whole in this country have seldom sold at such a level in the past. As a result of the great post-war upswing in prices, they did touch such a level in 1926, and passed well within it in the following two years. Hence it is necessary for investors who pay for future benefits to determine whether or not they are over-paying for them in purchasing common stocks for investment.

Considerations which govern the approximate determination of periods when speculative and cyclical factors place security prices on an exorbitant level are considered in Chapters XI above and XIV below.

Growth of Stock Holding

Public interest in common stocks as investments increased enormously after the close of the World War. Several factors combined to bring this result about, such as the great increase in the prosperity and stability of American corporations already referred to, the spread of security ownership in general owing to the great increase in individual wealth, and the customer and employee stock ownership campaigns of utilities and other large corporations, which habituated many people to stock ownership for the first time in their lives.

Estimates of the number of individual shareholders in this country can be made only with the greatest difficulty, because of the many companies for which data are unavailable and the many cases of duplication in shareholders even among companies which make public the number of individual names on their stock books. Thus, the American Telephone & Telegraph Company had, in 1929, almost 500,000 individual shareholders, but many of these were large holders of stocks in other companies as well. Some recent estimates which have been made place the total number of stockholders in this country at 15,000,000 and more.

Concrete evidence that stock holding is taking the place of real estate and bonds as the most prevalent form of investment in this country is given by statistics of estates filed for tax purposes with the federal government. The variation from 1923 to 1927 in the relative proportions of real estate, bonds and stocks in such estates is distinctly in favor of stocks. The changes were as follows:

	1923	1924	1925	1926	1927
Real estate	24.68	23.55	22.01	19.13	18.23
Bonds	14.96	14.79	15.57	16.17	14.77
Stocks	31.29	31.41	32.92	37.40	38.90

It is interesting to note that these figures of estates filed for tax purposes also reveal that real estate becomes of decreasing importance with the size of the estate. In gross estates of less than $50,000 in 1927, real estate constituted 39 per cent. This percentage decreased until it was less than 1 per cent in estates of more than $10,000,000.

In view of this extended popularity of common stocks, their selling price in relation to bonds may be permanently changed, as compared with pre-war days. Nevertheless, now that this change in common stock ownership has taken place, it may operate to reduce the extent to which further general advances in common stock prices may take place in the future.

Institutional Investments

Life insurance companies, savings banks, national banks, trust companies and other financial institutions which are supposed to be guided by considerations of maximum conservatism in their investment policies are almost universally restricted to bonds by law. In 1928, New York life insurance companies were allowed to invest in preferred stocks as well; but, as has been seen above, a well-protected preferred stock is essentially different from a bond only from a legal or nominal viewpoint.

Strange to say, proponents of the thesis that common stocks rather than bonds constitute the ideal investment medium have been especially vehement in their insistence that institutions of this kind, especially life insurance companies, should continue to be limited to bonds and mortgages in investing their funds. Thus, it has been stated:

> There is a vast difference between the investment needs and purposes of such institutions from those of the individual investor, or the family estate. Take an insurance company, for example. It is by the nature of its business perfectly safeguarded against any possible loss through the depreciation of the dollar. It deals in nothing but dollars. Its contracts call for the payment of future dollars. It therefore requires to know only that it will receive from its investments more future dollars than it will have to pay out. The purchasing power of these future dollars is of no concern to it. If dollars have shrunk in value, the beneficiary under its policies absorb the shrinkage, the company does not.[1]

The same reasoning is applied to savings banks, commercial banks and trust companies.

The fallacy underlying this sort of reasoning is obvious.

[1] SMITH, *opus cit.*, p. 11.

The writer assumes that these institutions are run for their own sake, and not for the investors who use them as media of investment. But they succeed in their object as investing institutions only in so far as they furnish a safe and reasonably lucrative investment medium. If the bondholder fares as badly as is claimed, then surely the savings bank depositor and the holder of a life insurance policy deserve equal sympathy. It is necessary to look beyond the institution to the men for whom the institution operates.

It is true that these institutions must be ready to meet their obligations in dollars whenever called upon to do so. But the experience of the past shows that at any one time only a small portion of their liabilities is likely to become payable, and they can surely realize as quickly upon a list of highly marketable stocks as upon a portfolio of long-term bonds. The chances of loss at the time of liquidation are exaggerated, by implication, in the above reasoning.

Whatever conclusion is applied to the position of the individual investor in the question of the relative merits of stocks and bonds naturally applies, with suitable modifications, to the investing institution and the institutional investor as well. At least a limited portion of the assets of such institutions certainly should be permitted to take the form of high-grade stocks meeting certain accepted tests of quality, for only in that way is the company protected to some extent against the dire effects of the changes in the value of money pointed out by the protagonists of common stocks. Of course, such institutions must retain their liquidity, and this can be protected both by requiring that part of the assets be invested in short-term securities of the highest grade and by insisting on a substantial degree of marketability for the remainder of the portfolio. But to favor common stocks for the estates of orphans, and to forbid them to the insurance companies formed to protect these same orphans, is an obvious contradiction.

To make such changes as a more enlightened, but not fanatical, attitude toward common stocks dictates would require a number of changes in the laws governing investments by these institutions, which have been reviewed briefly in Part I of this book in connection with these various institutions. This is necessarily a slow and long-drawn-out process, but it may well be hastened by the forces of competition. The rapid growth of the investment trust movement in this country after 1920, at a time when the savings banks showed slow progress, naturally made the latter envious. Individual savings bankers as a result have come out in favor of more liberal investment provisions in order to permit them to hold their own to some extent against the unrestricted institutions which, especially in a time of rapidly rising security prices, appear to the public to be the most profitable channel for investment.

Trust companies have been especially active in considering the wisdom of buying stocks for fiduciary investment, since they may secure the full right to invest in them through making suitable provision in the trust agreement. That this policy has had a certain amount of judicial sanction, as revealed in cases where beneficiaries have sought to recover losses from stock investment by trustees, is shown in the following statement of a trust officer:[1]

> The public who are the customers of the banks and trust companies not only request, they demand that trustees under wills and deeds of trust avail themselves of the advantages which the purchase of common stocks affords.
>
> This demand has already been met by some trustees. It is high time that all trust men declare unhesitatingly that it is and will continue to be part of their investment policy to buy common stocks for trust estates when properly authorized to do so.
>
> In every case which I have read in which the trustee has been surcharged for an investment in common stocks, anyone who had the proper conception of the duties of trusteeship, particularly the trust officers of the banks and trust companies of this country, would condemn the original action of the trustee in making the purchase and would give wholehearted approval to the decisions of the courts.
>
> Where the stocks bought are in any way representative and belong to that indefinite category of "investment" stocks, the cases disclose a tolerant and generous attitude on the part of the courts.
>
> We may confidently expect the support of the courts in an intelligent and reasonable investment program, including some common stocks, under a broad general power. But we must be highly discriminating in the selection of stocks before we buy them; and once bought, we must watch them with a minute and vigorous attentiveness.

[1] C. Allison Scully, Vice President of the National Bank of Commerce, before tenth Mid-Winter Conference of the trust companies division of the American Bankers' Association, 1929.

Preferred Stocks

The discussion thus far has been concerned with the characteristic features of common stocks and bonds when these types of securities are found in their original and typical forms. However, special intermediate types of securities exist which partake of the nature of one or both of these forms, while having certain special characteristics. The earliest form of special security is the preferred stock.

As preferred stocks constitute a large group of securities, their position is naturally a matter of importance. Essentially, a preferred stock is like a bond, if its legal features be ignored. Unless it has participating, convertible or other rights to a larger return than the stated preferential rate of dividend payments, it is a fixed-income security adversely affected by declines in the purchasing power of money and not benefiting from the piling up of equities through the corporate surplus.

The situation is different, of course, where the company is not in a strong cash position and where the preferred stock sells down to a relatively low level on account of uncertainty over dividend payments. In such circumstances, preferred stocks will move much as common stocks will, especially if dividends are cumulative and thus pile up when not paid. Thus, depending on the earning power of a corporation and its capitalization, preferred stocks vary in character from well-secured senior securities of large companies to non-dividend-paying stocks with remote possibilities of a return.

A statistical study of the past record of preferred stocks has been made to determine their market price performance, which resulted in the following conclusion:

> It appears that preferred stocks are a better investment than common stocks about as often as the opposite is true, when purchase is made for one year only. But it also appears that, when the line of common stocks swings above, it goes considerably farther above the line of preferred stocks than it goes below this line in the years when it swings below. That is to say, when the common stocks are better, their superiority is quite marked. When the preferred stocks are better, their superiority is much less in amount.[1]

[1] Jackson, James Roy, "Common and Preferred Stocks as Investments," *Journal of Business* of the University of Chicago, vol. i, pp. 294-323.

Hybrid Securities

The investment banking business, like any other, seeks to please the fancies of the public in order to stimulate its patronage. In the case of securities, this can often be effectively done by attaching to a bond or preferred stock which holds out to the investor safety of principal and regularity of income indirect participation in the ownership of the company.

Four important ways of doing this have been devised. The oldest and most common, until recently, was the convertible bond, which permits the bondholder to turn in his security and get stock in exchange at a fixed rate of conversion. A second method for accomplishing the same result is the giving of shares of stock as a bonus with the bonds or preferred stock, a method which had its heyday in the period of the early railroad promotions when the bonds covered the cost of the property and the stock was given away free to represent the good will. Strange to say, this scheme was revived in floating a number of investment trusts. A third method is the granting of option warrants to holders of bonds and preferred stock, which permit them to buy stock at specified prices. Lastly, the practice is not uncommon of selling blocks of bonds or preferred stocks with common shares, at a fixed price for the package. Thus, two shares of preferred stock may be sold with one share of common at a fixed price for the three, and the investor is given no choice in the matter—he must take the whole block or leave it. This method of financing also has been used extensively in the investment trust field, as well as in the financing of small industrials.

Fashions in the investment field change frequently. In times of rising stock prices, the attachment of the above indirect participations in the equity is often absolutely necessary to sell many issues. When prices are falling in the stock market, however, and confidence is at low ebb, such features often aid little in selling bonds or preferred stocks, price stability and yield then being the prime consideration.

The convertible bond or the bond with option or common stock attached is from many points of view the ideal security. It seems to protect the investor both ways. If the company is successful and conditions are favorable, the bondholder shares in the prosperity through conversion or purchase of stock below the market prices. On the other hand, should the value of the common stock decline sharply, it is altogether unlikely that the bond or preferred stock, with prior claims to earnings and assets, would suffer nearly as much. The record of these securities in the past has been generally good, comparing favorably with that of common stocks themselves.

However, the investor must be careful not to pay too much for his participation in the equity. There are many cases on record where the conversion or warrant feature merely concealed the innate weakness of a bond. Where the intrinsic investment security is weak, the investor should not be tempted to purchase an issue merely because a conversion or warrant feature of doubtful value is added.

Thus, a bond with warrant attached and a 5-per-cent coupon may be offered at 100, to give the investor a yield of 5 per cent. As a straight investment, let us assume a yield of 7 per cent should be expected, based on yields of similar securities in the market, so that the price would be, say, 85. The investor actually pays, in this case, 15 points for the warrant privilege, and he should decide whether it is worth the price.

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Chapter XIV

INVESTMENT AND THE BUSINESS CYCLE

Changes in Business

Modern business is in a constant state of flux. Periods of prosperity alternate with periods of depression. The volume of production rises and falls. There are times when employment is easy to secure and business enterprises are earning large profits, and other periods when unemployment is widespread, losses common, and economic conditions become generally bad.

This constantly changing state of business naturally has a powerful repercussion on the security markets, and therefore upon the business of investment banking. In this chapter, we are primarily concerned with the effects of these changes upon securities; but in order to trace them clearly it is necessary to briefly review the nature and causes of the business changes themselves.

Types of Business Fluctuations

Economists have for more than a century given careful thought to these changes in business. For a long time they were particularly concerned with the periodic spectacular collapse in business prosperity or panic which occurred several times during the nineteenth century—otherwise a time of rapid economic progress in western Europe and the United States—and theories of changes in business were called theories of panics or crises. In later years, they have come to consider changes in business as an organic whole, including in their studies the causes of prosperity as well as of panic and depression. This process of successive rise and fall is now generally defined as the "business cycle," a term applied to such changes many years ago by French writers and popularized in this country more recently by Wesley Clair Mitchell and others.

A major forward step in the study of business cycles was taken nearly a century ago by a French engineer and mathematical economist, obscure during his own lifetime but since celebrated as a remarkably original thinker in this field. A. A. Cournot distinguished three important types of changes in business, which are now termed secular, seasonal and cyclical.[1]

If we examine the trend of business activity in a country over a period of time, especially in one where the population is increasing, we generally find under modern conditions a steady increase in industrial, commercial and financial activity. Several reasons account for this usual trend under these conditions. The opening up of new lands, increasing technical knowledge, the discovery of new natural resources, the growth in international commerce—all of these factors are enabling the more advanced countries of the world, and especially newer regions such as the United States, to enjoy a steady expansion of economic activity. Such a long-term trend, covering, say, periods of fifty or one hundred years, is termed a secular change or secular trend.

A second form of change now generally segregated is the variation in business activity which occurs from one season of the year to another, reflecting special climatic and other factors. Thus, industrial activity in this country is greatest in the early spring and fall, as a rule. Agriculture is most active in the fall, when the majority of crops in the temperate zone are harvested. These regular seasonal changes in business continue to occur from year to year, despite the effects of secular growth. What secular growth, when it continues, does accomplish is to make each seasonal peak higher than before, while in the regular "slack" seasons business activity does not decline as far as previously.

"Cyclical" Changes

But it has long been observed that secular and seasonal changes in business activity do not alone explain variations

[1] Cournot did not distinguish seasonal fluctuations as such, using a category of "random" variations instead. See Moore, Henry Ludlow, *Generating Economic Cycles,* p. 2.

which are regularly taking place. In the United States, for example, there has been a secular growth in business activity from colonial times down to the present. Seasonal changes occur from year to year. Still, over and above these two types of variations, we have alternating periods of prosperity and depression. For a series of years, expansion becomes much more rapid than what is regarded as "normal," and the business organization of the country appears to enjoy an unwonted stimulation; then, more or less suddenly, a retrograde movement sets in, and perhaps for several successive years the secular upward movement comes to a virtual halt. The secular expansion of our business activity, therefore, does not proceed at a steady pace, but consists in periodic spurts of unusual activity, and subsequent reactions or recessions of greater or less duration.

It has become quite customary to represent these various business stages statistically. These representations consist as a rule in showing variations in indexes of business activity, relating to such basic business factors as car loadings, production of pig iron, building contracts, etc. The secular trend may be measured by fitting, through one or another of the common mathematical methods, a "trend line," while seasonal variations can be determined by a 12-months' moving average, or the link relative method. When the secular and seasonal trends are eliminated from the index, there is left the cyclical change alone, which shows deviations above or below a normal line.

The application of these mathematical methods results in a quantitative measurement of business changes which is to some extent spuriously exact. An index of basic business statistics is a rough average which only partially and approximately represents the true general business situation as it exists at any time. The application of mathematical curve-fitting methods to such statistics for the purpose of eliminating secular trend, and other methods for getting rid of seasonal variation, represents further approximations which makes the final results subject to a substantial measure of error. Hence, it is wise for the student to use these undoubtedly valuable statistical devices for segregating and measuring cyclical business changes with a full realization of their rough and approximate character, in order to avoid unjustifiable dogmatizing with them as a basis.

True Nature of the Business Cycle

The usual representation of a business cycle as a periodic change in statistical averages of business activity conceals the fact that different industries pass through cycles of their own, quite apart from that represented by any average or combination of different industries. Thus, the manufacture of railroad locomotives has followed in recent years a three- or four-year cycle. Locomotives have a life of fifteen or twenty years, often longer; and the insignificant amount of new railroad construction now going on makes the manufacturing companies rely practically entirely on replacement demand. The carriers have found it necessary to make large-scale replacements of engines periodically about every four years, so that locomotive manufacturing companies have found about one year in four prosperous, and these changes in their business occur without much reference to any general business cycle. On the other hand, certain new industries enjoy a spectacular and remarkable growth of their own without much regard to changes elsewhere—the automobile, radio, rayon and airplane industries being in this class.

The fact of the matter is, therefore, that the business cycle is a composite and approximate affair. During a period of prosperity more individual industries are active and profitable, while during a period of depression an unusual number of industries reduce their operations, throw people out of employment and report losses from operations.

The fact that individual industries enjoy their own cycles, and that the generalized "business cycle" usually referred to represents merely an average of conditions, is a factor of great importance from the point of view of the security markets. It means that different groups of securities will be subjected to varying conditions during any given period of prosperity or depression. Hence, any effects of the business cycle as a whole on the security markets which are here traced are understood to be general or average effects, subject to numerous exceptions and variations in individual cases.

Length and Amplitude of Business Cycles

During the earlier period of business cycle studies, efforts were made to find a regular periodicity in such changes and thus to develop a method of controlling or at least of forecasting them. Some writers spoke of twenty-year cycles, others of eight-year cycles, others of eleven-year cycles. They then sought to prove their contention as to the length of the cycle by applying refined curve-fitting methods to statistics of business changes. In this way, they succumbed to the dangers of regarding rough and approximate though mathematically correct methods as exact and accurate representations of the very complex business situation.

More recently, most writers on the subject have adopted a more realistic attitude, and have come to agree that the business cycle may be a generalized affair of varying length and amplitude, and that any regularity in its rhythm may be destroyed by such special events as wars, new inventions, new currency or banking legislation, etc. Periods of more or less sustained prosperity can be isolated covering five or six years on end, while others may last a year or two. The cyclical movement is in itself a generally admitted fact, but any regularity in its length or degree of variation is widely doubted.

Causes of the Cycle

The business cycle has thus been recognized and statistically measured. Students of these business changes have, however, differed keenly over their causes. Several score of explanations for the cycle have been advanced at one time or another, and many of them have enjoyed considerable vogue and have occasionally become a popular fashion in economic discussion.

These explanations fall into two broad groups—single and pluralistic. Among the single causes which have been advanced to explain the business cycle are rainfall variation, variation in the volume of building construction, excessive savings, excessive competition, over-capitalization of profits etc. But leading students of the subject have displayed a growing spirit of eclecticism, and to an increasing extent have recognized that cyclical business movements are the resultant of a variety of factors, and that at one time one of these factors, at other times another, plays the dominant rôle. The record of past theories is chiefly valuable, perhaps, as a caution against future attempts to dogmatize narrowly on the subject.

The modern view appears to be, therefore, that changes in business volume result from the action of a variety of factors. But one element stands out as of particular importance in connection with the business cycle, and that is changes in the general level of commodity prices.

Prices and the Business Cycle

Commodity prices for the most part show many changes over a period of time. These changes are far from uniform at any time, but here again an average of price changes can be secured through the device known as the index number, which generalizes the changes in a group of individual commodity prices. Now price changes as thus approximately measured have shown notable variations, as seen in the chart on page 299, and they have naturally had a very fundamental effect on the business cycle.

Changes in prices have themselves been the subject of careful study and considerable disagreement among economists. Some have explained them chiefly through variations in the volume of gold production, others through changes in the volume of bank credit. Still others have emphasized the importance of the evolution of more efficient production methods. At any rate, Fig. 10 already referred to showed that price changes have not been cyclical in character, and that they cannot be said to parallel with any exactness simultaneous cyclical changes in business activity. Hence, while price change may exercise an important rôle in shaping the course of the business cycle, it can hardly be said to be the sole factor, although one authority has actually written that such changes in commodity prices, that is, in the value or purchasing power of money, "is the business cycle."

It is probable that most economists would agree that a major change in prices would at any one time constitute a dominating factor in the business cycle. For if prices advance sharply at any one time, the result is a material increase in business profits and a strong temptation to business men to expand their productive activity in order to profit further from the rising prices. On the other hand, a sharp drop in general prices will cause most business men to lose money and therefore to curtail their operations. Hence, while wide price changes will have an important effect on the business cycle, moderate changes will be much less important.

In a more general sense, the price factor is considered by many to be of great importance in virtually every business cycle. The money economy which modern business has generally adopted is thought of by them as the basic reason for cyclical movements in business, for the entrepreneur and others carry on their calculations in terms of prices and profits, and base their operations thereon. Were the money economy to be swept away and a barter or communistic order established in its place, it is hazarded that cyclical changes could be eliminated. However, this statement raises broad theoretical questions which are not within the province of this chapter.

Business Cycles and Securities

The above *résumé* of business cycle theory is presented for the purpose of tracing the effects of these general business changes upon the position and prices of securities.

In the first place, a clear-cut division must be made for this purpose between securities receiving a fixed income, such as straight bonds and preferred stocks, and those receiving an income contingent upon earning power, that is, common stocks or convertible or participating bonds and preferred stocks. Each of these two main groups of securities is affected in a special way by changes in the business cycle, and to a large extent their prices vary in opposite directions.

There is, of course, no automatic or mechanical effect of business changes upon security prices. Whatever effects the business cycle may have are exercised through its influence upon the supply of, or demand for, any particular type of security. If changes in business activity resulted in no change in these two sets of factors, there would be no occasion for any resulting major variation in the level of security prices.

As a rule, however, changes in the state of business do exercise a profound effect upon these factors of supply and demand. More active business and higher profits mean a larger demand for capital, and thus lead to willingness by borrowers to pay a higher rate of interest on the securities they issue. On the other hand, rising business profits attract additional buying, partly of a speculative character based on borrowed funds, in the capital market. The bulk of this additional demand for securities, of course, turns at such times to issues of unlimited return which are in a position to benefit fully from the increase in the earning power of business enterprises, primarily common stocks.

It would be of great significance and value from the standpoint of an investment policy and as a practical guide in the making of investments, if some generalizations, even of the roughest kind, could be laid down with respect to the probable recurrence of the cyclical movements already mentioned. If this could be done, it is evident that intending purchasers could avoid placing their orders while prices were moving downward, and would wait for the most favorable conditions. In attempting to establish a basis for foreshadowing cyclical movements for this practical purpose, two factors appear to be of most interest. The first is the period which may be expected to elapse between "peaks" in security prices or, on the other hand, low points of such prices. The second and more important is the group of symptoms that are to be taken as indicative of the fact that the curve of business and values has reached or is about to reach the turning point, whether up or down. If actual light on these two groups of data can be had, the investor, particularly the large investor, is furnished with information of utmost value to him. He may make serious mistakes in his judgment with respect to any particular security, but these will tend to correct one another or to "average out," when judged in connection with the large number of securities. Since all securities of like terms and priority are affected in somewhat the same way by the general or underlying causes which it is sought to study, the thing most essential for the investor to know is the nature of these general or underlying causes. When once he is fully informed on this subject, he may with safety leave the other phases of the question to take care of themselves.

Phases of the Business Cycle

Do statistical data furnish any actual light upon the first of these questions—the probable period of the business cycle? We have already seen that there is an influential school of economists at the present time which is of the opinion that data are wanting to establish a belief in any given length of cycle; while a few add that the theory of cycles is not particularly affected by the period, and that there may be a succession of longer or shorter periods, without any uniformity, depending upon circumstances. To them the only essential or interesting phase of the whole question is the recognition of the distinguishing marks or phases characteristic of the upward and downward movements of business and values.

Four such successive phases are listed by recent authoritative writers, and the business cycle is identified with the successive recurrence of these phases in regular order. These are revival, prosperity, liquidation or, at times, panic and depression. From the standpoint of such writers, therefore, the significance of the business cycle in its practical bearing evidently centers around the question which we have listed above as the second of the two major problems—whether there are symptoms or characteristics which will render possible the determination of probable points at which a turn will be made. Evidently, if it be true that a business cycle is merely a succession of phases in the way just indicated, what is necessary chiefly is to recognize the particular phase through which the movement of values is at the moment passing. It is then possible, presumably, to foreshadow a characteristic modification of this movement of values as it passes on to other stages.

In order to trace more clearly the effects of the business cycle on the security markets, through these supply and demand factors, the status of the two important classes of securities—those of fixed income and those entitled to residual earnings of shares of common stock—should be studied in each stage of the cycle. Let us examine therefore the four phases through which values of all kinds are believed to pass in order to fulfil a complete cycle of movement. The first is designated by some writers as a phase of revival from a period of depression, and is characterized by increasing activity.

Securities During Periods of Business Revival

During such a period of increasing activity, the confidence of the investing public in the security market is not at first very great. Accordingly, there is a general tendency to seek what appear to be "safer" securities, and bonds are therefore in demand. At the same time, the increasing demand for credit as the revival proceeds may tend to raise interest rates slowly, so that the advancing tendency in bond prices may be halted as the revival goes forward.

Stock prices, on the other hand, will reflect the change in the business situation in a general way. The extent of this reflection will depend upon what is often called the "technical" position of the market. As prices tend to rise with the revival of business, heavy liquidation from hard-pressed former holders may prevent the rise from assuming large proportions for some time. At other occasions, when optimism concerning the future business situation is quickly established, a rapid advance may occur forthwith.

When differences of ideas as to the economic future make themselves evident, the process of stock trading passes into a new stage or phase. This may be called the period of accumulation. It is characterized by an effort on the part of traders, and especially large financial and industrial interests, to obtain as large quantities as possible of given issues in which they have confidence. Their optimism leads them to stand ready to pay higher prices than those which on the average have seemed to the rank and file of investors to be warranted. As a result, the values of the securities tend to advance, while the floating supply tends to become more and more closely massed in a relatively small number of hands.

Suppose, for example, that a given issue had been almost entirely concentrated in a few hands at the outset of, say, a five-year period. As time goes on, the business underlying the securities grows stronger. Earnings and dividends are increased. The public in general gradually becomes interested in such an issue, and during a period of revival in business activity its attention begins to be concentrated upon such opportunities. The period of accumulation, in fact, may be regarded as covering the trading which accompanies the growth of securities in power to earn. It may be replied that not all concerns are simultaneously showing an increase of earning power. There are, however, constantly recurring periods in which most securities are tending to advance, either because of increased earning power or because of prospective improvements in this respect. It should be noted, of course, that exceptions are always present. Failures are occurring constantly. What is here spoken of in connection with cyclical movements has reference only to general or average conditions which may be considered "normal."

In this accumulation stage it is probable that those who have confidence in their own ability to anticipate advances in values have borrowed from banks or other lenders as much as may be necessary to enable them to buy what they feel sure is likely to appreciate. The banks, on the other hand, have regulated their loans in accordance with what they suppose to be the dictates of safety. But in such cases the disposition is, of course, to allow lists of securities which are moving forward to be used as a basis for larger and larger loans of credit. Thus the upward movement or movement of accumulation tends to prolong itself because of the added impetus of speculative pyramiding.

Phase of Prosperity and Distribution

The prosperity phase of the business cycle is reached when the volume of activity goes above that indicated by the "normal" rate of growth. When the revival has proceeded far enough, various basic lines of industry generally find that they have an unusual quantity of orders, and expansion is in order. Thus, heavy building operations lead to large orders for steel, which in turn call for heavy coal production and increased railway traffic. The stimulation thus spreads from industry to industry, and may be hastened by rising prices occasioned by the keener demand. Fear of rising prices may result in large forward orders being placed, and when this occurs on a sufficiently large scale, boom conditions are said to exist.

The expansion characteristic of such periods results in an increasing demand for capital and rising interest rates. This tends to depress bond prices. In addition, the rapid growth of earnings reported at such times attracts the public to stocks, so that bonds decline in relative favor among investors. In the stock market, as prosperity unfolds itself, stocks rise sharply, above all as public enthusiasm is engendered by hopes of large speculative profits. The sharp increase in the volume of trading which usually occurs at such times is the best indication of the fact that the public is flocking into the market.

A time comes when, in the opinion of those informed buyers who had been purchasing stocks during the revival period, advantage may be gained by selling them. From their point of view, the general level of values is regarded as "too high." When is a security or group of securities too high? Fundamentally, of course, when the earnings, and hence the dividends paid, are below expectations which have been reflected in market prices. When such a situation occurs, those who are holding the security are warranted in the belief that a lower level of prices will shortly be established for it, since there are greater inducements to buy or hold other securities. It may be that the major inducement during the period of accumulation has been the fact that a given issue was thought to have some unusual business prospects. If the advance continues to a certain point, it may become evident that these have been fully realized or have turned out to be less satisfactory than expected. It may also be that in the process of borrowing money with which to carry such issues, commercial bank credit has been so heavily strained that the rate of interest has risen to a point which makes the cost of carrying heavier than the income, either actual or potential, to be realized from any possible further price rise. Whatever the cause, opinions change with reference to enough issues to bring about sales in volume larger than the current new buying demand at prevailing prices. A period of distribution or "unloading" then sets in; and during this period prices on the average remain unchanged and then move downward, as better-informed holders endeavor to dispose of their securities at prices which they believe are still in advance of the true levels of value dictated by information or new developments which have become known in connection with securities. Thus a "sellers' market" is developed. As during the period of accumulation, there may be and probably are many exceptions furnished by the issues which have power to resist the general trend of things. But liquidation in one section of the market tends to affect others, so that if the selling is drastic, few securities may be able to avoid its effects.

As the decline in stocks gets under way at the end of a period of prosperity, bond prices generally continue to drop. The liquidation of bonds is partly a result of efforts by speculators to curtail their operations by selling securities which have declined least. That a change in the trend of interest rates is at hand may be ignored by the market under such circumstances. Thus, for example, the efforts to distribute bonds in the early spring of 1929 were unsuccessful because of the pressure on the stock market. Also, there was a general feeling that rates of interest in the money market were high and likely to go higher for a time, so that a possible buyer with funds at his command could earn more by lending them on call, where the yield was greatest and absolute liquidity was secured. The effort to sell stocks by large industrial and financial interests in order to distribute them to individuals may or may not be accompanied by a downward price movement at first. Such sales may be made at a time when rumors or actual evidence indicate an improved state of earnings and dividends, so that a buying fever sets in and a large enough demand is called into play to absorb the offerings which have been placed on the market. Distribution, then, often takes place with a well-maintained or even rising price level, due to the fact that the buying public at large is of the opinion that business opportunities warrant strong confidence in the future price level.

Liquidation or Panic

The pendulum of business prosperity almost inevitably swings too far, leading to a reaction which often is proportional in its severity and extent to the preceding upswing. In the business field, this reaction reflects the over-production which often takes place during the enthusiasm of the boom, and the sudden falling off of orders and, often, decline in prices which occurs when it is realized that the expected continued increase in business volume is not materializing. In the security field, speculation based on the discounting of future increases in corporate earnings and dividends collapses, and liquidation follows, in which values are readjusted to accord with the real underlying conditions.

The symptoms of this change in the business situation differ in individual cases. In most instances in the past, persistent expansion in the volume of production, rising commodity prices, an apparent shortage of many types of goods and high interest rates have been common characteristic symptoms of such a turn in the business situation.

If the liquidation reaches panic proportions, all security prices may be swept downward without exception. When the reaction is less severe, selling of stocks may be accompanied by buying of bonds as investors seek to safeguard their principal by placing their money in protected, fixed-income-bearing securities. Also, as interest rates drop with the decline in the market, further stimulus appears to encourage buying of bonds. A major rise in bond prices has, in the past, often dated from a period of severe liquidation or panic in the stock market.

The rise in stock prices generally has culminated before the period of severe liquidation or panic arrives. By that time, the leading financial and industrial interests have generally distributed their stock to the public. Professional speculators may still be active in the market, but it is common for this element to be caught in the toils of the panic because of their desire to continue profitable operations as long as possible. As liquidation develops, the decline in stock prices tends to be extremely rapid because of the impairment of speculative margin accounts. Just as in the rise of stock prices speculators pyramid their commitments, using paper profits on one transaction to support another, so on the decline the wiping out of margins in one commitment compels throwing other holdings overboard. Furthermore, panic conditions are characterized by a general shortage of bank credit because of the caution of bankers and the general "freezing" of the credit situation, and at such times call money rates may rise to fanciful figures for a time.

Phase of Depression

The final stage in the so-called cycle of investment events may be described as a period of depression. During this period business conditions are settling down and activity is at low ebb. Stock prices are adjusting themselves to the new circumstances which have been developed during the downward movement, and which have almost invariably resulted in a great deal of unevenness and irregularity as between different securities. Imperfections of competition, lack of opportunity to judge accurately of the relative merits of given securities, and other factors of the same sort have produced a "ragged" appearance in the general field of security values, with the result that a process of readjustment is needed.

The stock market at such times is essentially a "traders' market," and values fluctuate irregularly around the general average low level that has been established in the process of driving prices downward. Very likely the elements in the level of values thus established have a relationship one to another which is quite different from that which they bore when at high point.

As the period of depression and impaired general confidence continues, a surplus of funds awaiting investment accumulates. This surplus gradually finds its way into bonds and the best investment stocks. Interest rates decline as the demand for capital continues small in the face of this increasing supply, so that bond prices may well enjoy a major upward movement. Only as signs of business revival multiply does buying of stocks, especially of a speculative character, again attain substantial proportions.

Relation to an Investment Policy

Such a cyclical movement as we have traced naturally has an important relationship to our theory of investment. The investor will normally desire to stay out of the stock market and to keep his funds in the form of bank credit or high-grade bonds as far as possible at times when stocks are at the top of the curve or, as it is popularly stated, "when the market is high." Conversely, he will feel like converting his funds and bonds into stocks, to some extent whenever he believes that the market is at a low point and a revival of business is at hand. Obviously, if all investors were perfectly informed and acted under the same impulses, whatever investment cycle there might be would be largely "ironed out." Since all would refrain from buying at the high point and all would enter the market at the low, high and low points would tend to disappear.

Buyers and sellers are, of course, not actuated by any such common motive or body of information; on the contrary, a great many of them analyze the market quite differently from others and buy when others are selling. Again, it is also true that there are numerous investors who find it necessary, because of large income, to buy practically steadily regardless of cyclical fluctuations of this sort. Again, there are others who prefer not to sacrifice the regular income which is lost in keeping funds idle, but prefer to make long-term commitments without regard to capital gain. The result is that fairly well-defined swings in the market may be recognized. Certain investors do more or less successfully adapt themselves to such movements, holding back their buying when they think that lower prices are in sight, or borrowing from banks and anticipating their income when they believe that higher values are probable. Speculators, of course, seek to do this continually. These operations result in emphasizing at times the cyclical swings or movements to which reference has been made. To some extent, doubtless, statistical analysis can and does succeed in recognizing, and perhaps occasionally for short periods anticipating, the trends of stock prices. The belief that this can be done is widespread, and unquestionably influences in an important way the action of many groups of investors who would otherwise follow out a rather different policy, certainly at what are believed to be turning points in the market. But experience has shown that such forecasting under present conditions is a very difficult matter and is subject to so many uncertainties as to make it completely untrustworthy.

Problem of Forecasting

In the effort to adapt himself to changes in the business cycle, such as those just indicated in the foregoing paragraph, the investor naturally encounters the question whether it is possible by any "system" to forecast the movement of the market or of the principal shares therein. Various agencies which purport to forecast the course of prices have been formed, and they offer to the public "services" which are designed to perform this function in some way.

Clearly, they all depend for their success upon the existence of a definite business cycle which is reflected in investment values in substantially the way that has just been indicated in the foregoing paragraphs of this chapter. They are naturally able to furnish only very rough and approximate indications of changes in values; and those who are wisest undertake to do no more than to indicate alterations in fundamental factors, such as activity of trade, employment, output, price movements and the like, leaving the investor to draw his own inferences for the most part.

Efforts to facilitate such forecasting by preparing a composite index of business, and the parallel effort to make up composite indexes of securities thought to represent the average or general situation of the investment market at any given time, have not been successful. They undertake to average things which are dissimilar in kind and which therefore are not capable of being united. Moreover, it is to be borne in mind, as already indicated, that general conditions which act alike upon all groups of values are not numerous; and that, so far as they exist, they are likely to be neutralized by offsetting conditions which operate to render nugatory various factors or elements which might otherwise make for an advance or a decline at a given moment. Forecasting therefore is not as popular as it once was; and in so far as it is successfully practiced at all, it takes the form today largely of forecasting as to individual securities or groups of securities in which factors of earnings, assets, management and the like are carefully estimated and then studied in their relationship to the more general influences operative in the market.

Some International Aspects

The business cycle has some important international aspects. It has been observed for some time past that the series of changes known as the business cycle seldom occurred simultaneously in all countries. What used to be termed a "panic" or depression usually "started" in a particular country or market, advanced to a fairly well-recognized point, and then "spread" into other affiliated markets. Occasionally there were markets or countries which did not seem to suffer from it at all, or which felt the effect of it so late that it was not ascribed to the same set of influences.

Similar conditions may be observed from the reverse side in the case of prosperity or advance in business. Activity may be pronounced in given branches of business in a certain country long before it is apparent in other countries, and general employment and prosperity may take their rise in one country and then be gradually transferred to others. In the same way, movements of prices may start in one country and gain a considerable degree of advance there before they are recognized anywhere else. Noting this difference in the stages or degree of progress of the cyclical movement, some investors have been inclined to the opinion that they could detect the existence of such difference in degree of advancement through statistical and other analysis, and so could transfer funds from one country to another in such a way as to anticipate the later changes in security prices. This effort is made, for example, by some investment trusts which believe that they may successfully sell out in a country where securities are over-valued and seem to be tending downward, and thereafter shift their funds to a country where securities are depressed but seem on the whole tending upward.

The fact is that there often exists a plethora of funds in one market, and at the same time a corresponding shortage in another. But those discrepancies do not automatically adjust themselves, and so such international diversification may not prove to be a profitable policy. The "high" market may go much higher while the depressed market remains low. This was the case, after 1926, with investment trusts which sought to protect themselves from a decline in the rapidly rising American market by buying in such countries as Germany, where money was very scarce and prices stayed low.

Business Cycle and Investment Banking

It is thus evident that the investment banking business, like other forms of business, may be much affected by the changes which we have designated as the business cycle. It is influenced by them in two major ways. First, the cyclical changes in business affect the quotations of securities, and therefore the conditions and prices at which new issues can be marketed. Secondly, the business cycle has an important influence upon the attitude and buying power of investors with regard to offerings made through investment banking channels. The policy of the investment banker necessarily must be to adapt himself to such changes and to avoid any injurious or embarrassing effects which they may produce upon his own operations. Such possible influences may be briefly summarized as follows:

1. It not infrequently happens that investment bankers obligate themselves to "bring out" a number of issues of securities at a price or rate which proves to be out of harmony with the market rate, the latter changing as business cycle conditions shift and change. Excess inventories at such times are as dangerous as in other industries. Such a situation, resulting as it does in an unfavorable commitment and consequent loss, can be avoided only through careful watching of the market and more or less successful forecasting of tendencies. Another remedy is the reduction of the time that elapses between the purchase of the issue and its sale to investors.

2. Investment bankers frequently find it necessary to get accommodation from commercial banks for the purpose of carrying unsold portions of an issue, and then find themselves subjected to loss through the development of high short-term

rates which inflict upon them a loss equal to the difference between the long-term interest on the securities which they are carrying and the short-term interest which they are paying to the bankers for current accommodation. This situation can be avoided only through careful adjustment to money market conditions and more or less successful foreshadowing of short-term rates in the open market.

3. The investment banking house which is internationally organized has always to choose between the markets in which it will offer a given security issue or the apportionment which it will make of a given issue between such markets. This involves a study of the relative position of such markets, and a corresponding adaptation of rates and terms in one to the corresponding rates and terms which are being fixed in the other. Errors in this matter, if made, necessarily throw the dealings of the house in one market out of gear with its dealings in the other, and may result in the arbitraging of securities between the two markets under conditions unfavorable to the investment house.

Therefore a definite policy of investment management on the part of the house of issue, based upon the idea of a business cycle and designed so far as possible to foreshadow business cycle changes, becomes practically a necessary instrument in investment banking operations, as currently conducted.

Investment bankers can further protect themselves to some extent against adverse effects from the business cycle through the combining of several types of business within one organization; and this factor has been one of the major incentives to the combination of functions which has been common in recent years. Thus, a house handling only bonds may have little to do in times of active stock market speculation; but if it has a stock brokerage department also, or an "over-the-counter" market department, it is prepared to expand its stock business at such times. Investment trusts provide a means of taking advantage of periods of depressed security prices when investors are unwilling to buy directly. Finally, brokerage houses with commodity trading departments may make money from these when the security markets generally are depressed.

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Chapter XV

INVESTMENT CREDIT ANALYSIS

The Importance of Earning Power

The analysis of investment credit differs in several fundamental respects from that of commercial credit. The two chief differences are the liquidity and price factors.

Commercial credit analysis seeks to determine primarily the liquidity of a loan. Provided the borrower has cash on hand to liquidate the loan at maturity, little else is of great importance. A weak borrower can borrow money freely in many cases by hypothecating satisfactory collateral with a bank. The collateral, through assuring the liquidity of the loan, makes the credit transaction possible and often quite desirable from the viewpoint of the lender.

In investment credit analysis, liquidity in this sense is not a factor at all in most cases. Investment securities for the most part are either long-term bonds, which generally need not be paid off because they can be refunded, or shares of stock which have no maturity. Therefore the possession of the principal amount of the commitment in cash at an early date is not necessary. Liquidity for the holder of the security is obtained, in fact, through the quality of marketability, which permits the sale of the security to another investor in the open market, and thus its transformation into cash without a material decline in price.

Instead of liquidity, it is earning power which nowadays receives the major stress in investment credit analysis,[1] for such earning power is the chief basis of satisfactory marketability. If present and prospective earning power assures the regular payment of a return on a security, the indicated value

[1] Where earning power is legally made to depend to some extent on asset values, as in the case of railroads and public utilities, this statement must be modified.

of that security becomes the capitalized value of such return. In the case of a commercial loan, the long-range future outlook for the enterprise is not the vital factor in credit analysis. It is otherwise, however, in investment credit analysis, for the analysis of earning power must look forward over a period of years if the estimates of earning power are to be of any value.

The basic approach in investment credit analysis, therefore, is the capitalization of prospective earning power. In the case of bonds, this earning power is limited by contract to the coupon rate of interest, and the chief element in the analysis is the determination of the extent to which the earning power of the enterprise is likely to cover bond interest requirements. The wider the margin of surplus earnings over and above interest requirements, the more secure is the bond in the enjoyment of its regular stated return. Well-secured preferred stocks are in the same position.

In the analysis of stocks, the problem is far more complex. Since common stocks represent equities, they are entitled to all the earnings left to the corporation after paying prior charges. Hence, the indicated value of stocks equals the capitalized value of all estimated potential earning power. But estimates will vary widely and will change frequently as information is made available on the prospects and current operations and financial returns of the company. Furthermore, the rate of capitalization—the determination whether certain stocks should sell at ten, twelve or twenty times present or prospective earning power, for example—will change in response to a variety of factors. Constant changes in estimates of earning power and rates of capitalization are reflected in the wide fluctuations of stock prices.

The Price Factor

The second characteristic of investment securities is the constant change in price which they undergo. Commercial credit instruments generally call for a fixed rate of interest, which is deducted in advance in the case of notes and drafts discounted at a bank. These instruments do not take the form of specific issues with characteristic price variations, as is the case with investment securities. But because bonds and stocks are long-term securities, the market is constantly changing its valuation of them, resulting in a constant fluctuation in their market quotations. In the case of well-secured bonds, this price variation is of limited proportions, although over a period of years it may be substantial. Stocks vary in price over a very wide range because of great changes in earning power and rates of capitalization which take place in the course of time.

Now security analysis, where the information is available and good judgment is applied in using it, can determine with a fair degree of accuracy the present and, to a lesser extent, the future indicated earning power behind an individual issue. It can measure certain other elements of value. But it cannot dictate to the market what should be the general level of interest rates, or what should be the general rate of capitalization of the indicated earning power of common stocks, for, as has been seen in the preceding chapter, these factors are difficult to appraise in advance. The result is that security analysis does not permit the determination of what the price should be. Judgments as to price are purely empirical—they can be based only on comparisons with other similar securities. Through using current methods of security analysis, it may be possible to say that Security A has the same indicated value as Security B. If the latter sells much lower then the former, it appears to be "out of line" and should appreciate in price if the market finally discounts this fact. But discrepancies in selling price often persist indefinitely, and the predicted price change may never occur.

Thus, investment credit analysis, because of the important part played by the market price factor, is always subject to wide margins of errors. Market price is not always rational price, no matter what the basis of comparison. Classical economists sought to avoid this difficulty by positing a "normal" or "real" price, around which the market price is supposed to fluctuate. Whatever the logical basis of such a concept, it is worse than useless in practice, and its use by security analysts merely leads them to make dogmatic assertions and prophecies, many of which are never fulfilled.

Basis of Security Prices

The security analysis problem in actual practice requires a judgment as to price. But, as has been seen, the exact part of the analysis refers only to a number of pertinent and ascertainable facts which affect value. The actual judgment of the market place interprets these facts in different ways at different times.

In the case of bonds and preferred stocks assured by their quality of a certain fixed income, analysts are fairly well agreed that the price is fixed at a point where the yield is large enough to give a return equal to the market rate of interest on the capital investment, plus a premium for risk. As seen in Chapter X, the general rate of interest changes in response to the action of a variety of factors. The premium for risk is an individual matter, varying with the conditions which apply to each security.

These two factors which are supposed to determine the value of securities receiving a return fixed by contract are, standing alone, an inadequate explanation of the true market situation, however. In practice, anything which will make people buy more of a bond issue will raise its price. Some such factors are sponsorship by a strong banking house, marketability, legality for institutional investment and tax exemption privileges. On the other hand, anything which will discourage demand, such as lack of public knowledge about the issue, "foreignness," etc., will tend to reduce the price below the general level for similar securities. To say that market price is fixed at a point where it results in a yield large enough to give a pure interest return plus a premium for risk, is to overlook the fact that the market is not ultra-rational. However, it is probably true that in the long run prices tend to result in larger yields roughly proportional to the risk involved; and it is the function of informed security analysis to see that the yield on any given issue is adequate, considering the return on other issues of equal risk, and to pick out those which for one reason or another are under-valued by the general run of security buyers.

With regard to securities with no limited return, consisting of common and participating preferred stocks, market value is based upon different considerations. Should the earnings of the company grow, the result will not be merely less risk with regard to the receipt of a fixed income return, but rather an increase in the return received. This increase may take the form of a larger cash return or of stock dividends and other benefits such as are commonly enjoyed by stockholders in successful companies. The prices of common stocks of successful companies thus tend to rise to a point where direct cash dividend income equals less than a pure interest return. It will approximate, in fact, a pure interest return, less expectations of benefits to be received. Hence, in capitalizing the indicated earning power behind the security of a prosperous, growing and well-managed company, the market may regard its stock as worth fully twenty times current earning power, whereas the securities of a backward concern may sell at only five times present earning power. The market thus looks forward to future earning power, and changes its basis of capitalization accordingly.

It is from the long-range viewpoint that the analysis of stock and bond values comes down to the same thing. Over a period of years, in so far as investors act rationally the ultimate yields on both types of securities tend to become equal. If more is earned out of holding stocks, they are generally sure as a class to rise in price sooner or later to reflect and discount this. Both will tend to sell at prices where the yield to the investor reflects a reasonable return for the risks involved over and above a rate of interest for the use of capital. It cannot be too strongly emphasized, however, that at any one time in the market very marked discrepancies will arise between price and quality, which may persist for years on end.

Assets vs. Earnings

In considering the basis of security prices and the measurement of the risks surrounding them, earning power has been given first place in the above discussion. This is the generally accepted view of the correct procedure at the present time; but in times past asset values were stressed to a far greater extent. The theory advanced was that earnings fluctuate with changes in business conditions, but assets have a fixed value which can be realized in case of need. It has been only as a result of experience, which has shown that assets frequently have little value if they do not yield income, that the general attitude has changed.

The change which has taken place in the point of view of modern credit analysis is described as follows by one investment banker:[1]

> Until fairly recently, reputable investment bankers were more impressed by a photograph of a large and impressive factory than by any painted picture of possible or even probable future profits. They were accused by seekers after capital with looking at a concern's assets not as the profit-making tools of a going business, but much as a pawn broker might, with an eye to their possible value as unredeemed pledges.
>
> Under old conditions of business the investment banker was indubitably following the safe and sound course. But as business has changed, the attitude of bankers has altered to conform with conditions as they are. To a great extent he is reflecting the demands of the investing public, which has seen business with great assets turn out to be poor investments and others enhance greatly in value because of increasing earning power. Today the banker will undertake the financing of a concern with negligible fixed assets, provided he is convinced that the prospects for increasing earnings in the future are good.

The fact is that capital invested in fixed assets is not mobile and cannot be transferred when it becomes unprofitable. Hence, a lien on assets may prove to be a wholly illusory safeguard at the very time when it becomes necessary to rely on it—when earnings fall off.

Analysis of Risk

From what has been said above, it is evident that in the analysis of investment credit the measurement of risk plays a leading part. Investment, as distinct from speculation, has already been described as a long-term commitment of funds made in such a way as to avoid major risks. It is a function of investment credit analysis, therefore, to appraise these risks in the case of each individual security, to determine how great they are and how likely they are to grow greater or less in the future.

Risk measurement becomes a highly complex process in the

[1] WILLIAM R. BASSET, member of Spencer Trask & Co., in the New York *Evening Post Annual Financial Review*, January 3, 1929.

light of the numerous factors surrounding modern enterprise in its manifold phases. The measurement of the risk attaching to a Roumanian bond is an entirely different thing from measuring the risk involved in the debenture of an ice-cream combination. Nevertheless, the investment banker, and the investor after him, must make an appraisal in each case which will result in fixing a yield basis for each of these two securities that will reflect the degree of risk inherent in each of them. All securities, no matter how diverse in character, must be compared by the common denominator of yield and market price.

The extent to which the process of risk measurement can be carried depends upon the sources of information developed and the amount of original research done, as well as upon engineering surveys and accounting analyses that can be obtained by the buyer of the securities. The individual purchaser of securities generally does very little along these lines as a rule; the investment banker and the large investing institutions often do a great deal. In this chapter, we are concerned primarily with the current practice of the investment middleman, especially the larger houses of origination, and the large investing institutions, in measuring credit risks. The complexity of the problem is recognized as preventing a uniform treatment of credit analysis in all phases, and accordingly a preliminary survey will be made of the major features of the analysis process as adopted for each group of securities in current practice. Great strides are being made, with the growth of the investment banking business in this country, in improving this crucial function of credit analysis; and what is presented here is not necessarily the best practice, but an indication rather of what is being done by an average firm.

The Real Estate Mortgage

The mortgage on real property has everywhere constituted one of the earliest and simplest investment media. Especially in a great new country like the United States, raising money on the security of the land has from the beginning constituted a major portion of the field of investment banking. The measurement of credit risk here has, as a result of the long period of experience enjoyed in this field, become a highly developed art.

From time immemorial, the value of a lien on real property has been determined roughly by the market value of the property itself. The earning power has generally been a secondary consideration because of the comparatively easy marketability of real estate. If the property has a going value of considerably more than the amount loaned on it, a default could be met without much danger of loss to the mortgagee. The relatively standardized character of real estate has resulted in this stress on asset value remaining a dominant factor in analysis down to the present date. This asset value in turn, however, reflects in the main the present or prospective earning power of the property.

A prime reason for the secondary position of earning power is the relative ease with which many types of land can be shifted from one use to the other. Unimproved land is especially adaptable in this respect; but even buildings have this feature—a town residence can become a commercial building, for instance—so that a minimum market value can be found for practically any real property as a result of a wide demand for it from many different types of buyers. Of course, there are many individual exceptions to this rule.

The chief part of the credit analysis process, as now developed in the real estate field, is the determination of the property value. This is done through appraisal. Appraisal is usually accomplished on the basis of indicated market value as shown by sales of similar property, with allowances made as a result of expert consideration of various factors affecting the present and future earning power of the property. The loan as made is equal to a certain percentage of this appraised value. The earning power plays an important rôle in determining the percentage that many real estate mortgage houses will advance on any one piece of real property.

Railroad Security Analysis

The first great development of the American investment banking business was predicated largely on the financing of our great transportation enterprises. The rails continued to attract the bulk of interest in our security markets down to the beginning of the present century, when the period of industrial amalgamation created a number of industrial stocks and bonds that could compare in size and stability with the issues of our leading railroad systems. In fact, only during the past two decades have the railroads been definitely allocated to a minor place as compared with the whole field of industrials, and the industry is yet to be found that can compare with the carriers in the total volume of outstanding securities. Our American railroads have a total of well over twenty billions in securities outstanding.

Because of the all-important part played by the American railroads in the development of our security markets for a period of nearly a hundred years, the principles of risk appraisement and investment credit analysis were early developed here. Furthermore, the evolution of analysis methods has been carried farthest in this field; and it is no exaggeration to say that in no other field of investment is it possible to measure risks more finely. The reasons are that sources of information and agencies to facilitate the job of credit analysis have, during this long period, developed highly advanced methods of analysis, and have then worked up the means of securing the needed information.

The general principle of risk measurement in the case of railroad securities is not different from that of the real estate mortgage. There are the dual safeguards of earning power and property value to be taken into account. However, unlike most real estate properties, capital invested in a railroad enterprise has little of that quality which the economists call mobility. If a railroad is poorly conceived and badly located, the investment can seldom be salvaged. Instead, the fixed charges on the property will have to be cut down or eliminated, and if the enterprise is entirely unnecessary, it may be completely scrapped, as has happened to not a few railroads in this country.

Because of the relative immobility of capital invested in railroad enterprises, earning power becomes the paramount consideration. While property value is given substantial consideration, for most railroads can earn something even under very adverse circumstances, the bondholder knows that the mere possession of a lot of physical assets will avail him little if these assets cannot produce an adequate revenue. When such a revenue is continuously produced, he cares little as to how many times the physical value of the assets covers the amount of indebtedness of the corporation. Accordingly, in measuring the value of a railroad bond, the number of times interest is earned is the chief factor analyzed. Similarly, the number of dollars earned per share on railroad stock is the chief item studied in analyzing railroad stocks. Book values of assets follow as of secondary importance.

But long ago it was learned that earning reports and balance sheets can be juggled, and that a good showing one year, even without such juggling, is by no means a certain indication that prosperity will continue in the future. Such basic considerations as traffic and physical conditions had to be analyzed to get a clue as to intrinsic and future earning power. Accordingly, the work of credit analysis was carried further and further, first by the great railroad banking houses who had to put out new issues of securities from time to time and, above all, reorganize old railroads which had found their earnings inadequate, and later by the life insurance companies and other big investors.

We can only summarize here what has been accomplished in the development of a technique of railroad credit analysis. The Interstate Commerce Commission in 1907 established a uniform accounting system. Since then, more and more data have been made available in carefully compiled form, so that now the full light of publicity has been thrown upon most of the operations of the carriers.

But such statistics are not enough for the purpose. The last word in railroad analysis has been accomplished by a coöperative organization of insurance companies and other leading investing institutions and large investors, established as a result of repeated railroad reorganizations. This coöperative organization, known as H. H. Copeland & Son, collects basic operating data on each section of railroad line in the country against which securities are outstanding. In this way, the traffic moving over each sector of railroad can be carefully watched from year to year, signs of unhealthy trends noted, and the securities sold if thought wise. While this service, because of the great expense involved, is not directly available to the general public, the latter of course benefits through the superior measure of safety thereby accorded insurance company, savings bank and trust company investments in railroad securities. Furthermore, these data are available to many leading railroad security houses, enabling them to be guided accordingly in their railroad issues.

The flotation of new railroad security issues is now a cut and dried affair. No new railroads of any importance are being built, the financing in this field being done practically entirely by the old established systems which are ever growing in size and importance. Any new issue of securities, with few exceptions, constitutes merely a relatively small addition to an already large outstanding issue, with a definite market value. That market value is established chiefly by the large institutional demand for these bonds. Thus, the investment banker plays a minor part in the creation of a market for railroad issues now, as the main buyers, with their exceptionally complete sources of information, constitute an already existing demand for an issue of any conceivable size.

The most delicate problems of analysis really arise in connection with reorganizations of bankrupt railroads. Here, the claims of the different liens on and equities in the property must be carefully adjusted in the light of legal and economic considerations. As a result of the unusually complete data on railroad operations available, the analysis of the equity behind each lien is now based on such fundamental considerations as the number of ton-miles moved for each dollar of debt outstanding, and the relative physical condition and strategic importance of the property covered by the lien.

Public Utility Securities

The task of analyzing the risk inherent in a public utility security is considerably more complex and difficult than is the case for a railroad bond or stock. The reasons for this are several. There is no federal regulation of the utilities, and therefore the uniform accounting and statistical data made available by the Interstate Commerce Commission have no counterpart in the utility field. Secondly, there are several different types of utilities—electric light and power, street railways, natural and manufactured gas, telephone, water and, according to some, even ice manufacture and distribution—making the problem of analysis by no means uniform. In the third place, there is no such elaborate development of sources of information as in the railroad field, and the utility companies have shown themselves far less willing to give full data on their operations to the large investing interests. While analysis methods in the public utility field are not, therefore, as well developed as in the case of the railroads, they are tending to evolve in the same direction.

In measuring the earning power of public utilities, it is necessary to study carefully the depreciation policy followed, because of the lack of uniformity in this respect and the resultant distortion of indicated earning power by a number of companies. As many public utility issues are even yet, despite the numerous recent consolidations, relatively small in size, the investment banking house plays a far more active rôle in establishing the credit standing of individual issues than is true for the railroads. Accordingly, their analysis activities are frequently far more thoroughgoing and complete. Engineering reports on the construction and condition of the properties are generally used to supplement the accounting data; and to an increasing extent such data as investment and funded debt per kilowatt-hour of capacity are being developed and made criteria of credit position.

One further interesting difference exists between credit analysis on a railroad and a public utility property. The utility is a rapidly growing enterprise, as a rule, while the railroad is a relatively stable affair that will generally show little change in total volume of traffic from year to year. A utility which is unable to show a 5-per-cent average increase in the volume of business each year is an exception—most of the leading companies show a much faster rate of growth. This permits the analysis to be made with allowances for increased earning power resulting from the indicated future growth. Utility analysis thus involves a forward-looking attitude not usually feasible in the case of the railroads, because of the growing competition the latter meet from motor vehicles.

The present movement toward increasingly large amalgamations in the public utility industries will tend to simplify largely the function of credit analysis and to make the problem more and more similar to that of analyzing railroad securities. The big combinations, although adopting the holding company form because of the necessity of retaining the local corporate entities which received the original local charters, have tended to combine their financing to an increasing extent. In many such amalgamations, such as the Associated Gas & Electric Company and the Public Service Corporation of New Jersey, scores of subsidiary securities have been eliminated by exchange or redemption, and replaced by a few large and more easily analyzed issues.

Industrial Analysis

Their legal monopoly, the close government regulation and the basic nature of the services they render, place the railroads and public utility concerns in a class apart. The number of risks is reduced, thus simplifying and rendering more definite the problems of investment analysis. For the great majority of industrial concerns, the analysis problem becomes far more difficult. In fact, in the case of many industrial securities the information generally available is so fragmentary that rumor and vague conjecture must be relied on almost exclusively in analyzing values.

Because of the many uncertainties which surround investment in the industrial field, the burden of credit analysis rests more heavily on the investment banker. Studies of entire industries and individual securities are constantly being made, either for the purpose of floating new issues, or purchasing blocks of securities for secondary distribution, or as a general service to clients. The broad outlines of such a study of an industrial security are indicated herewith.

Earning power is the starting point of practically every one of these studies. Asset value plays a relatively unimportant part, for unprofitable assets are not worth much, especially in a highly competitive industry where a small and efficient producer can rapidly displace the large but poorly organized and inefficient firm. The unimportance of asset value in determining the selling price of industrial securities is set forth in the following table, comparing asset value and selling price of several leading industrial stocks on December 31, 1928:

Stock issue	Book asset value per share	Market price per share
American Can	$ 50.88	110⅜
American Tobacco	45.67	176
American Woolen	119.47	27⅛
General Motors	15.54	81½
Nash Motors	19.68	108½
R. H. Macy Corporation	96.88	185
U. S. Rubber Company	48.79	46¾
U. S. Steel Corporation	208.87	141⅜
Woolworth (F. W.) Corporation	37.57	215

The reason for the disparity between book and asset values is that the element of good will plays so important a part in industrial valuation. Good will in its broadest sense is excess earning power above a moderate return on the actual investment in the enterprise. Certain industrial concerns, badly managed and suffering from obsolescence, show an element of "ill will," that is, the securities sell for less than the value of the assets. Thus, on December 31, 1928, the selling price of the preferred and common stocks of the United States Rubber Company amounted to $126,353,904. The book value of the assets, less funded debt and current liabilities, was $191,451,360 on that date. The "ill will" of this concern thus amounted to $65,097,456.

This earning power, however, is difficult of determination in many cases because of the lack of uniformity in accounting practice. All kinds of special items might conceal the true state of affairs. Depreciation is one factor that is especially subject to wide variation. In some cases, an abnormally favorable showing is made through insufficient write-offs on this account. In other cases, earnings are concealed for years through over-liberal depreciation entries, the sums reserved for depreciation of plant being used in fact largely to rebuild the properties of the company. When this program is completed, a sudden jump may occur in the reported earning power of the company.

Another analysis problem of special importance in the case of industrials is that of inventory. Most concerns in this group keep substantial stocks of materials and finished goods on hand, and these items fluctuate in price. When these price changes are substantial they may be a determining influence on earning power. A sharp decline in prices, by causing severe inventory depreciation, may change an operating profit to a heavy net loss for the year. The oil and rubber industries have suffered particularly from inventory fluctuations, and in times of sudden price declines, such as 1920 and 1921, the profits of years may be wiped out in a short time.

Reported and prospective earning power may be entirely different for an industrial corporation. One main factor which may undermine earnings is competition, from which railroads and utilities are virtually free. Competition often leads to over-production and price cutting, and has abruptly changed the fortunes of countless business enterprises in the past. Technological change is another factor which must be considered. The annals of American industry over the past three decades include many a tale of the rise and fall of industries, industrial methods and distribution systems. These changes have resulted in huge profits to many concerns—they have also wiped out numerous others.

After the earnings, the working capital position of the company is of great importance. A large working capital means protection for the company against temporary adverse developments, and gives it the means to expand when the opportunity arrives. It also constitutes some protection for the permanence of interest and dividend payments on the company's securities. In the analysis of the working capital position, a number of factors may be revealed concerning the position of and outlook for the concern. Working capital, including all those assets which, in the ordinary course of business, are converted into cash, is composed of three chief items—inventory, accounts receivable and cash. The inventory item is the one needing most careful study, as has been seen. Cash and its equivalent, such as marketable securities, constitute, of course, the most desirable form of current asset. Similarly, current liabilities differ in quality. Liabilities coming due within a period of one year, exclusive of funded debt, are generally placed in this category. The item of notes payable, representing usually loans from banks, is rapidly disappearing from the balance sheets of the larger industrial concerns, as an increasing proportion of them retain enough permanent working capital in the business from surplus earnings and security issues to take care of all usual demands.

The adequacy of working capital is measured as a ratio of current assets and liabilities, as well as the net amount of current assets, less current liabilities. No arbitrary ideal ratios and amounts can be set, however, because of the great diversity in practice among individual industries and firms.

The fixed assets of the company, as has been seen, are of minor importance as far as book values go. However, the condition and modernity of the plant are of great importance, as well as its capacity. Frequently the company's reports are poor indications of this. An investment banking house will often resort to special engineering surveys, or at least to a general tour of inspection by officials of the firm, before reaching a conclusion as to the merit of an enterprise.

Where patents and trade marks are involved, due allowance must be made for rapid changes in value which might take place. Thousands of valuable patents are constantly becoming valueless because they are replaced by superior devices and methods. Similarly, unless backed up by constant advertising and careful merchandising methods, trade marks can gradually lose their value, as has been abundantly proved time and again in the field of tobacco manufacturing.

Finally, the management factor is of great importance, although not easily measured. With regard to the analysis of this factor, the Industrial Securities Committee of the Investment Bankers Association of America has this to say:

> Management seems to be conceded by all to be the most important requisite. The Baltimore & Ohio Railroad has recently celebrated its 100th anniversary. Yet how many of us buy clothes and necessaries at the same shop for more than perhaps ten years, how many use the same make of automobile for more than such a period? These concisely stated ideas, to our mind, most clearly point out to the investment banker the prime necessity of studying the management of a company he is considering and the practicing of eternal vigilance in watching that management, after the securities have been marketed. Too often has it happened in the past that a management which has built up a successful business, having sold that business to the public through security issues, becomes lax and careless, and too often has it happened that the banker who placed those securities had not kept in close enough touch with the management to protect his interests and those of the public—which are one and the same.

As a result of the consolidation movement which has affected nearly all branches of American industry over the past thirty years, this broad group of securities is taking a leading place in our financial activity. Accordingly, a growing tendency has arisen for investment banking houses to develop organizations which are proficient in the analysis of one or more specific groups of industrial issues in which they specialize. One leading firm in New York City, for example, specializes in chain and department store financing; another, in aviation issues. In this way, a growing mass of facts and experience is attained to simplify the analysis problem for such specializing houses.

Securities of Financial Institutions

A very important group of securities, with a market value aggregating several billions of dollars, are the issues of financial institutions. Bank and insurance shares are entirely of one class, for these organizations do not issue preferred stock or bonds. Hence, the complicating factor of trading on the equity is eliminated; but to offset this apparent simplification of the analysis problem, there is a great paucity of information regarding the true position of perhaps a majority of these financial institutions.

While it is true that banks and insurance companies are rigidly regulated in this country, there are some aspects of their business concerning which information is not generally available. Among banks, this is especially true of the operations of investment subsidiaries, where large profits may be made or losses incurred without publicity. Similarly, insurance companies, especially those operating in the fire and casualty field, can deal in the security markets and make large profits there. All in all, therefore, analysis of bank and insurance securities on the basis of published statistics often errs widely, so that market prices of these securities often appear to bear little relation to published statistics of earnings and book value.

In the case of investment trusts, analysis is all the more difficult because the buying and selling of securities is the stated business of such companies. Investment trusts secure income from interest and dividend payments on the securities in their portfolio and, in addition, make profits or suffer losses from turning over their securities in the market. This latter income will naturally vary considerably with the state of the security markets. It would obviously be imprudent to capitalize the earnings of either a very good year or a very poor year in the security markets. As a matter of fact, investment trust common stocks commonly sell at some mid-point between a capitalization of earning power, including turnover profits, and the usually smaller book value of the shares, based on the securities in the portfolio.

Municipal Analysis

In analyzing municipal bonds, a significant variation in emphasis is noted. A governmental body usually relies chiefly upon the taxation power for its revenues, although some income-producing activities may be carried on by it. Normally, this taxation power is sufficient to cover all financial needs, including service on the debt. Hence, provided the legal aspects of the issue are proper, the credit risk becomes a small one.

Therefore, in the case of the general run of municipal bonds, it is necessary to pay particular attention to the question of the validity of the issue in the light of the legal requirements of the laws governing it. One of the most important statements to be noted in connection with such issues is that a prominent firm of lawyers has examined the validity of the issue and found it satisfactory.

Beyond this question of legality, the same tests apply as in the case of corporate issues. The determination of the ability to pay, as measured by the size of the tax burden in relation to the wealth and income of the community, is the purpose of most such statistical analyses of municipal bonds. Any limitation on the taxing power by constitutional provision, or otherwise, militates strongly against the investment quality of such bonds, for it results in limiting the income available to pay interest and principal on the issue. Also, in the case of new communities, or those dependent upon such temporary industries as oil drilling and mining, the credit risks become substantial because of the possibilities that the community will disappear along with the industry which gave it life.

Specific tests of municipal credit have been worked out on the basis of the amount of debt in relation to the population and the assessed valuation of property within the jurisdiction of the issuing body. These tests, like all ratios between greatly varying factors, have little meaning without careful interpretation.

The small margin of profit in the municipal bond business, and the fact that the demand for these issues comes chiefly from wealthy investors who wish to enjoy the benefit of the tax-exemption features they possess, result in making this branch of the business a rather specialized affair. A limited number of investment houses pay more than incidental attention to municipal bonds.

Foreign Security Analysis

When the investment banker crosses a political frontier and purchases a foreign security, a number of new problems arise in investment credit analysis. Political risks, legal risks, currency risks and other new factors enter into the situation, which are not normally taken into account to any extent in domestic financing. Furthermore, differences of language and business practices make it more difficult to secure and interpret the requisite information.

Foreign securities have played an important rôle in the American capital market only since 1920. At first, banking houses here depended upon established European contacts, especially with the great banks there, to aid them in the problem of credit analysis. However, the foreign departments of our leading investment banking houses have steadily expanded in scope and improved in efficiency. Lately the Investment Bankers Association has sought to place the gathering of information about foreign securities upon a coöperative basis through the establishment of the Institute of International Finance.

In the case of foreign securities, the vague and purely empirical connection which exists between the facts as revealed by analysis and market price is especially apparent. For example, a bond of a first-class foreign public utility company should admittedly give the investor a higher yield than a similar issue of a domestic utility. The difference in yield would reflect primarily the political risk involved, as well as the "psychological" distrust many investors have toward foreign securities, thus reducing the demand for them. In practice, however, this difference in yield has varied sharply, without much regard to changes in the intrinsic quality of the securities. Thus, during the five years after 1920, foreign bonds as a whole steadily appreciated in value, although a number of them suffered wide fluctuations in price until such time as the public became accustomed to purchase them for investment purposes. From 1925 to 1928, a vast increase occurred in the quantity of new foreign securities appearing on this market, and the additional yield required by investors fell sharply, until many foreign issues were giving less than one per cent additional yield, as compared with similar domestic issues. With the great increase in interest in common stock investment that occurred in 1928, foreign securities quickly fell out of favor again, and our investors once more demanded a much higher yield from them as compared with similar American issues.

Growth of Information Sources

There has been a great expansion in the quantity and variety of financial statistics which have been made available to the public during the past few years. This has resulted in part from the tendency of corporations to publish fuller and more complete reports about their activities. It has also been caused in part by the wide distribution of security ownership in recent years, which has made it possible for large statistical organizations and many financial journals and periodicals to subsist by furnishing financial information to their clients. Finally, investment banking houses have found that public interest in securities is stimulated through free publication of facts about them, and the average new security issue now is accompanied by considerably more information for the public than was the case in the past.

The individual investor is gradually getting to a point where he is actually deluged with information of a financial character. The result is not always fortunate from his point of view. The major portion of the information made available to him may be of a biased or interested nature. Investment banking houses tend to present to him information about those securities in which they are interested, rather than those which constitute the best bargains in the market. Financial journals and periodicals tend, often quite against their wishes, to print a disproportionate amount of favorable information about securities which are being manipulated upward and are therefore the subject of favorable announcements or analyses by those interested in them. Hence, the individual investor who chooses to take care of his own affairs cannot give up his independence of judgment if he wishes to run his investments in a way likely to conduce to his own best advantage. He must seek information everywhere, but he also should scrutinize it as to its reliability and value as far as possible.

At any rate, it would appear that the period of financial illiteracy in this country is slowly passing. A knowledge of the fundamentals of the security markets is being spread among all classes of the population, and an increasing number of people are able to do some thinking for themselves in the matter of security buying and selling. As a result, the appraisal of investment credit is becoming to an increasing extent the consensus of opinion of a large number of individuals, and in the course of time this may well bring about a closer correspondence of security prices to the known facts as brought out by informed security analysis.

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Chapter XVI

INVESTMENT CREDIT INSURANCE

Insurance and Investments

In a former chapter (Chapter V), it has been seen that there was good reason for regarding the insurance companies as an important factor in the investment market. Their chief function in that connection was found to be the purchase and holding of large volumes of securities bought for the purpose of keeping their funds at work and thereby earning an income which would render it possible to reduce the cost of policies to the holders thereof. This was regarded as unquestionably a fundamental phase of the relationship between the insurance companies and the market. In another way, however, the general principle of insurance is significant in connection with investment. The latter contribution on their part is furnished by their recently-developed function in connection with the insurance of credit.

Insurance in the abstract is essentially defined as the process of spreading out risk or loss, so that a great number of persons combine to carry losses which grow out of the incurring of risk at unforeseen or incalculable times, when the necessity of carrying such loss individually would result in extreme suffering. The life or fire insurance company thus accumulates funds from a great number of persons, and in return agrees to pay a specified sum to any one of these contributors or named beneficiaries contingent upon such stated events as death, the occurrence of fire, or some other risk.

It has been seen in an earlier chapter (Chapter XI) that one reason why securities differ in their yield is found in the element of risk; and that as the possibility of loss of principal in whole or in part, or suspension of interest, becomes greater, the rate of interest charged is correspondingly enlarged. In other words, the risk element in investment is practically always present, although in greatly varying degrees. The question has, therefore, arisen whether it may not be possible, by means of insurance, to eliminate this risk, or at least to reduce it to a negligible quantity. It has been argued that if such risk could be eliminated, the result would be to place the whole process of investment upon a much more secure and stable basis, and to enable the individual to apply his funds with a greater feeling of security, due to the fact that his risk as an investor had been assumed by a strong company which was entirely able to carry it. Out of this have arisen various proposals for security insurance or guaranty, which are coming to attract increasing attention in the financial community, and which deserve correspondingly careful consideration, although only a very small volume of securities have as yet been affected by such schemes.

Before taking up the subject in detail, however, it is necessary to consider some misapprehensions which have been allowed to grow up around this topic. First of all, it should be remembered that insurance companies never insure (and never can insure) against a loss that is certain. They would, for example, never undertake to insure a group of tuberculosis patients upon the same basis that they would apply to persons in full health—indeed, most insurance companies would refuse to insure them at any price. In the same way, a marine insurance company would not knowingly admit as the holder of its policy an obviously unseaworthy vessel, even though it might be simultaneously insuring a great number of highly seaworthy ships upon which it received premiums which would cover the loss incurred from the sinking of the unseaworthy boat. By the same token, it is out of the question for any kind of insurance plan to take the risk entirely "out" of investment. All that such a company can do is to estimate as carefully as possible what that risk is, leaving out such issues as appear to be certain failures, and then to assume, by the process of averaging, the risk of loss resulting from it. The insurance company is able to do this only by reason of two facts: (1) that it presumably has a larger and more accurate supply of information than its individual customers concerning security risks and loss possibilities on an actuarial basis,

(2) that inasmuch as it gets an insurance premium from a considerable number of customers, it is able to spread out the loss incurred by any one individual over a much greater number, so that the losses incurred become an element in the cost of doing business which can be regularly ascertained and provided for out of the premium income, instead of a destructive blow or shock which may put an individual concern out of business. Remembering this generalization, it will be clear that the business of insuring investments can succeed only in so far as the risk to be taken is measurable or capable of standardization or estimate, and that it can be assumed even in that case only on large specified classes of substantially similar obligations; and, finally, that the risk is never really eliminated, but is simply borne by contributions made by a large number of insured individuals, and so reduced to a fixed and uniform premium charge.

Insurance by Endorsement or Guarantee

We may now examine cursorily the methods of insuring against investment risks. The most elementary or primitive of these is furnished by the idea of endorsement and guarantee. Thus, in commercial banking, let us suppose, there is doubt about a customer's ability to pay his debt. The banker then induces the customer to provide an endorser or guarantor, who becomes jointly liable with the signer of the obligation. In time, an individual or firm may make a business of giving such endorsement or guarantee, charging a commission or fee for so doing, as is the practice of the discount and acceptance houses of Great Britain and of accepting banks in the United States and other countries. But this is a later development, and the idea of endorsement in its elementary form consists merely of a reduction of risk through adding one additional obligor.

In the field of investment, this endorsement principle is very common. Numerous individual concerns undertake to guarantee or insure an entire series of obligations or capital stock issued by another. In connection with consolidations, and incorporate relations in general, one concern finds it to its interest to guarantee the securities of another in lieu of purchasing them, or merely to give them a better credit standing so that they become more effective as a new financing medium. Good examples of this kind of insurance or guarantee were first furnished by railroads, which frequently guaranteed one another's bonds and stocks as one line absorbed others and, instead of retiring the obligations of the latter, simply made them their own, that is, guaranteed or insured them. In all instances of endorsement, there is an order of liability prescribed by law; but in the last analysis, both parties who have put their names to the paper are responsible for it, and it may be collected of one or the other. In the case of the guaranteed bonds already spoken of, the obligation is a lien upon the property which has been given as security for it, and a claim against the issuing company; and after that has been exhausted, the guaranteeing enterprise is responsible for any balance of liability that may remain.

Making Insurance a Business

The question, of course, early arises whether insurance or guarantee may be reduced to a business basis, so that it no longer becomes a mere incidental result of mergers or combinations between concerns. Special corporations may be organized which, for a fee, offer to guarantee the obligations of others by adding their endorsement. Accordingly, the notion of organized credit insurance has developed, and today plays a small rôle in the investment market.

This process is currently carried out in two main forms. In some cases it consists in substituting the name and credit of one corporation for those of another. In others, it is based upon the issuing of a definite contract of insurance covering all risks of a certain kind that are assumed by the guarantor corporation. In the first case, obviously, the insuring concern takes upon itself a specified liability and agrees to meet it, collecting of course from the enterprise which is being insured in the event of a failure on the part of the latter to meet its obligations. In the second case, the guarantor concern does not substitute its own name directly, but it does indicate in some way the fact that it has guaranteed the obligation, and that in the event of a default upon it, the insuring concern may be relied upon to make good. It is worth while to see exactly how far these two plans have been carried out in the investment world, and also what are the limits of their probable success, as well as their cost. The chief applications of both of these methods of credit insurance are to be found in the real estate financing field, although there have been others, as will be seen presently.

Substitution of Names

We may begin with the idea of the substitution of names in the process of protecting obligations. Perhaps the best original example of this substitution principle is furnished by the banker's acceptance. In this type of paper, two individuals are presumably engaged in trade, one buying from the other, but not being in position to pay this other in cash. He therefore offers to obtain for the seller the promise of a bank to pay his obligations; and accordingly, when a draft is drawn by the seller of goods, it is by prior agreement presented, not to the buyer, but to a banker, for acceptance. The latter accepts it, and so makes himself liable for the amount due, and the seller can thus depend absolutely upon the banker instead of upon his customer. Of course, the accepting bank cannot afford to grant this substitution of name without first making a thorough study of the credit of his customer. When he has made such a study he may decide that the credit of the customer is good enough to warrant him in taking merely the customer's own obligation, and giving the customer his acceptance upon such paper as the latter may desire to have drawn upon him. Here, there has been a substitution of the banker's own credit for that of the customer. It is the fullest kind of guarantee, since the banker undertakes to place himself in the same position of liability that the customer would, had the latter accepted the paper. Such paper, when issued by strong banks, becomes the best type of short-term investment, and is accordingly much sought by bankers who have funds to employ in liquid form at short term.

The oldest example of the use of substitution of names in purely investment banking is probably found in mortgage banking, which has been discussed in Chapter VI above. It was there seen that the mortgage bank issues its own obligations in order to raise funds to buy individual farm mortgages, thus placing its well-known and well-regarded credit in the place of that of the unknown small borrower who has no access to the capital market directly. In several European countries, such as Germany and Finland, the mortgage banking principle has been applied to industrial financing, and there are industrial mortgage banks that make long-term advances to corporations, receiving individual secured obligations which are made the basis for the flotation of bonds and stock of the bank itself. Several real estate mortgage firms operating in urban centers, as well as many public utility companies, have worked on the same principle, issuing their own collateral trust obligations against numerous individual mortgages or, in the latter cases, security issues.

Furthermore, several of the large installment financing concerns are operating on the same principle. These concerns offer to finance the purchase of machinery and other permanent equipment for industrial enterprises, receiving a mortgage on these assets to secure the loan. Capital is then raised in the market through bond and stock issues of the finance company, which thus substitutes its name for that of the individual, often comparatively small, business concern.

Guarantee or Insurance by Contract

The second method of credit insurance may now be considered, where the guarantee is accomplished by contract rather than by direct substitution of names. The guarantor then assumes merely a secondary liability in case the given security does not prove to be good. In the case of short-term paper, this is furnished by a bank endorsement. A customer who wishes to sell his paper in the open market may thus induce a banker to endorse a draft instead of accepting it. The real liability on the part of the insuring or endorsing institution is the same in this case as it is when one name is substituted for another, except that the liability does not become operative until after that of the actual maker of the paper has been found to be inadequate, *i.e.*, until a default has occurred.

In investment banking, the chief application of this idea is seen in the organization of enterprises whose sole business, or an important department of whose business, is found in thus guaranteeing the reliability of real estate mortgage obligations. This process essentially consists in testing the character of the credit for which insurance is sought, and then issuing a policy of insurance to cover the payment of principal and interest on the mortgages accepted. This is termed mortgage guarantee, and is an outgrowth of the original limited insurance functions connected with real estate financing which consisted in the guarantee of title to the real estate that was being made the basis for a mortgage loan.

In many of our larger cities at the present time trust companies or title companies, or concerns performing both kinds of service, are in the habit of guaranteeing mortgages. They give to the customer who purchases from them the actual mortgage, which they themselves have received from a borrower, an endorsement, either actually written upon the instrument itself or conveyed in a separate document, whereby they undertake to pay to the purchaser the face of the mortgage in the event that it should at any time be defaulted. They also guarantee the regularity and full payment of interest in the same way, and incidentally they carry on the business of insuring and guaranteeing the soundness of the titles to property which has been mortgaged. This they are able to do, as will presently be seen, by reason of the fact that they have taken a large number of obligations of this kind and, on the principle of averages, can be reasonably sure that the losses incurred in a certain volume of dealings will not be greater than can be provided against by the taking of a small fee, usually in the form of a deduction from the specified rate of interest, the proceeds of which are used to establish a reserve against loss. On high-grade real estate mortgages and mortgage bonds, one-half of one per cent is frequently charged as a premium, so that a mortgage that pays 6 per cent in interest will yield the investor 5½ per cent if guaranteed.

Another development in the field of mortgage guarantee has been the segregation of the insurance function from that of the purchase and sale of mortgages. In fact, those trust and mortgage companies which do arrange to guarantee their own mortgages for a fee frequently incorporate separate guarantee companies, in order clearly to segregate the liability. In other cases, concerns which specialize in this business are asked to guarantee mortgages sold by various real estate mortgage or bond houses. This permits widespread diversification of risk by the guaranteeing concern.

Of course, the value of the guarantee is no greater than the financial strength of the guarantee company. If the assets of the latter are insufficient to meet losses at any time, it becomes insolvent, and the guarantee may become of little or no value. In a few isolated instances this has happened; but in the great majority of cases the guarantee principle has in practice been applied with success in the real estate mortgage, and mortgage bond fields.

Before taking up the possibility of the application of investment credit insurance to a broader field, it will be instructive to review very briefly what has been done in this connection in the commercial credit field, where there has been more experience in the broad use of this device. It has there become a not infrequent practice among sellers of goods or lenders thereon to take out insurance of this kind.

Technique of Commercial Credit Insurance

Credit insurance is a guarantee that a beneficiary shall not suffer from those losses occurring because of the insolvency of debtors coming within the coverage of the policy which are in excess of the normal loss from bad debts incident to his particular business. The insuring company guarantees to pay the policyholder the net excess over this normal loss. The contract between the company and the insured is variously called a credit insurance policy, a bond of indemnity, or a contract of guarantee on insolvent debtors' accounts.

In addition to covering only abnormal or excess losses, every credit insurance policy contains several other fundamental features. These may be summarized as follows:

(1) The maximum amount covered on any single account which the insured sells is specified, according to the rating of the debtor.

(2) Co-insurance, or bearing of part of the risk by the insured, is generally required to give the insured an interest in collecting debts.

(3) Further co-insurance is required on sales by the insured to inferior rated risks, and an additional premium is charged for covering such risks.

The policy also may or may not contain either of two other features:

(1) A maximum total liability of the company under the policy, which is called a limited policy; or no limit to the amount of the liability of the company on the aggregate of accounts covered, called an unlimited policy.

(2) A provision for collection of past due accounts by the company.

A merchant's outstanding accounts vary according to his terms of sale, but are said usually to range from 15 to 25 per cent of his annual sales, averaging about 20 per cent. With annual sales of $1,000,000, about $200,000 will generally be outstanding in receivables. Of this $200,000, from 10 to 20 per cent will usually be past due. The policy of a merchant toward his past-due accounts largely determines his loss ratio.

Instead of exacting a cash premium to cover the losses normally incident to the business insured, plus the loading for the excess, it is believed to be more practical and more satisfactory, and to remove any speculative feature, simply to exact a smaller cash premium, and to provide that the policyholder shall bear the loss normal to his business (which he may not lose during some years), and receive reimbursement from the insurance company for the losses in excess of the normal. The normal loss is calculable, and may be considered in the same manner as other items of manufacturing and selling cost in arriving at the selling price of merchandise. Moreover, having the policyholder bear the normal loss reduces, as stated, his cash premium by a considerable amount, so that it is much less than that charged for any other form of insurance. If the average fire loss is one-half of 1 per cent of the values insured, the policyholder must pay in money not less than one-half of 1 per cent for fire insurance, plus overhead expense and profit; whereas if the average credit loss on goods sold is one-half of 1 per cent, and the merchant loses less than this, he retains the difference between his actual loss and this average loss, for he does not pay the company a premium for any part of his normal loss.

Field for Investment Credit Insurance

We now turn to a consideration of the question of how far this insurance system is likely to go in the investment field, and what are the principles upon which it must be conducted. The first of these questions is answered when we have an answer to the second, inasmuch as the study of the principles of the business furnishes a clue to the extent to which it may be expected that such principles will be applied in actual practice. The major aspects of the principles involved in credit insurance have already been indicated in a preliminary way. From this it appears that the basic necessity in this, as in all cases where insurance is applied, is a careful selection and standardization of risks.

By selection and standardization of risks is meant the ascertainment of the degree of risk which is likely to be incurred in insuring or guaranteeing against any particular event. For example, in life insurance, policy rates are based fundamentally upon the ascertained normal death rate of individuals in average good health at specified dates. The policy rate grows higher as the individual increases in age, because he has a smaller number of years to live. It also grows higher as the individual engages in more and more hazardous occupations or transfers his place of residence to less salubrious climates. Thus the insurance rates in the tropics are materially higher than those in the temperate zones. The same principle may be applied in connection with investment credit insurance, provided that the credit risk can be ascertained and classified with a fair degree of accuracy so as to assign it to the limited number of cases in which the risk of loss has been established through experience.

Careful work of this kind, of course, presupposes intelligent credit analysis antecedent to the issue of securities which are to be guaranteed. In the case of a corporation whose bonds are to be guaranteed, for example, the credit analysis will involve a careful study of statements of earnings, financial position, etc., followed by further investigations of various kinds to establish character and by inquiry designed to bring out the nature of current changes in business conditions. As a result of these investigations, it is possible to establish a ratio of loss growing out of similar securities in a large aggregate of cases, and so to determine what the charge for insurance should be on a thousand dollars of such paper. The credit analysis thus described may be developed to a scientific statistical basis wherever it is possible to ascertain that substantially identical accounting methods are used, so that it may be definitely known what conditions in a business of given size, relating to earnings, capital assets and liability, sales volume, expense ratios, and so forth, should roughly exist. This data, analyzed from an actuarial standpoint, would make it possible to insure or guarantee all corporation bonds in the same way that real estate mortgages are guaranteed, without involving an excessive charge, such as is always necessary where insurance rates are based on inadequate information.

Limitations on Method

It is evident that the limitations which are naturally applicable to this method are those which grow out of the fact that, in many cases, securities which are issued in large volume involve so great a possibility of risk in the aggregate that the companies which are engaged in making the guarantees have only an insufficient capital with which to carry on the business and assume the hazard. It would be rather useless to insure a million-dollar building in a company that had only a few hundred thousand of capital; since, in the event of destruction, the concern would not be able to meet its risks—unless, of course, it had protected itself by reinsurance. To put this briefly, the capital which is now available in the business of insuring investment securities has not been developed upon a scale adequate to the size of the risk to be insured. Moreover, so recent has been the development of industry upon a basis of corporate capitalization, that there is still a very insufficient and scanty body of data upon which to base the calculations of risk probability. An immediate limit to progress is thus afforded by the lack of statistical experience, which prevents the scientific working out of the ratios of loss on an actuarial basis that must govern in given cases.

Real estate mortgage guarantees have the advantage of attaching to relatively small single issues, so that a single loss as a rule involves only a negligible portion of the total assets of the guarantee company. In case of corporate or government bonds, the insurance company which sets out to guarantee such issues may suffer an enormous loss through a single default. In the general investment field, therefore, there is a serious problem involved in the large size and resulting reduced diversification of probable losses.

Another problem arises in connection with the determination of the risk, because of the complexity of the corporate mortgage and the legal uncertainty surrounding its exact position. The investment credit insurance company which sets out to guarantee many bonds of a large issue against default must be able to determine the position of that issue in the event of receivership and foreclosure. This is frequently very difficult, and in many receiverships it takes extended litigation to determine the exact position of single liens. There has been an interlacing and overlapping of obligations through mergers and other corporate developments, which makes the prior determination of asset protection often open to a wide margin of error.

It should be added that, particularly in the United States, there has been a rapid development of different types of financing and new kinds of obligations. This fact alone would make it out of the question to develop the practice of guaranteeing very far in the case of these newer types of obligations, however possible it might be in the case of those types that are older and have had a longer experience upon which to fall back for statistical guidance.

The application of the guarantee principle to stocks seems to be a vague and impracticable matter, because of the much larger number of uncertain elements involved. Earning power, dividend policy, industrial change, working capital position and numerous other factors directly affect stock values to a varying extent, and the application of actuarial principles as yet would appear to be out of the question.

Insurance Through Diversification

The aim of insurance is to spread risk. This can be accomplished directly by the investor, or more effectively by an investing institution, through the acquisition of a diversified list of securities, so that losses in one or a few may be offset by more favorable results in others. Just as the Pennsylvania Railroad, for example, can insure its own property because it is so widely scattered that fires and other physical losses can consume only a relatively small portion of the total assets at any one time, so an investor whose funds are large enough to permit him to acquire a substantial number of securities of different issues, has a reduced need for anything like investment credit insurance.

Diversification generally takes place along four different lines. First, there is diversification between stocks and bonds, so that conditions which arise to affect adversely one of these two broad classes of securities will be more or less offset by contrary effects on the value of the other. In the second place, there is the question of diversification between different companies in the same industry. Thus, we have had in recent years the development of specialized investment trusts in the mining, chain store and aviation fields which seek to reduce risks by purchasing a diversified group of securities within their special fields. Thirdly, there is industrial diversification, whereby the investor can spread his risks over several industries, and thus avoid the risk of too heavy losses by adverse conditions in any one line of activity. Fourthly, there is geographical diversification, involving the placing of commitments in several countries to avoid dependence upon any one financial market which has peculiar economic, financial and political risks of its own.

In proportion, therefore, as the size of an investment fund grows, the need for credit insurance becomes less. One of the great advantages of the investment trust and other investing institutions, although not the only one, is this possibility of working out broad diversification with a large fund.

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Part Three

INVESTMENT BANKING PRACTICE

Chapter XVII

NEGOTIATION AND PURCHASE OF NEW SECURITY ISSUES

Policy in Purchasing

In many respects, the origination of new security issues is the most difficult and important of the functions of the investment house. From a purely selfish point of view, sound purchasing policies are essential for two vital reasons. In the first place, a security issue well-bought is half sold, a rule of merchandising that applies in the securities business as much as, or more than, it does elsewhere. Secondly, the future of the investment house is closely bound up with the character and record of its past offerings. The ability to sell securities possessed by these houses is based on public confidence in them, and the confidence of the public can be secured only through a successful record of issues which have been sound and profitable over a period of time.

From the social viewpoint also, the purchase function of the investment house is of first importance. As the investment banker chooses, among the numerous financing propositions brought to him, those he will accept, he unconsciously directs the flow of the community's capital into certain channels and away from others. In this way, he acts as arbiter of the future of governments and industries. It is true that this dependence on the investment banker varies with the strength of the organizations with which he deals, for governments like those of the United States and Great Britain and corporations like the Ford Motors Company and the Standard Oil Company are so strong as to need little, if any, aid from investment bankers in approaching the capital market. But under present conditions, the smaller countries of Europe and South America, and the bulk of our larger corporate enterprises still depend on the investment house for effective access to the capital markets at reasonable cost.

In this chapter, current practice in the negotiation and purchase of new security issues is described. Wide variations exist in methods followed by different houses, so what is presented here is chiefly an exposition of practices used by the larger houses, and may be regarded as representing a fairly standardized mode of procedure.

Channels for New Financing Proposals

Most of the larger investment houses receive regularly far more proposals for new financing than they can or care to handle. Before considering the methods by which these proposals are analyzed and then rejected or accepted, we shall first take up the various channels by which most of these propositions reach the individual investment house. Six of the most important channels are:

1. Financial and personal relations between the investment banking house and the applicant
2. Branches, traveling representatives and negotiators
3. Banks and correspondents
4. Direct application to the investment house
5. Competitive bids
6. Joining with originating houses in syndicates

Each of these channels will be considered in turn.

1. It is a general rule followed in relations between investment bankers and their customers, that "one good deal deserves another." Therefore, when the investment house has once given satisfaction by selling a security issue effectively, there results as a rule a permanent connection between the issuing government or corporation and the banker. This relationship varies widely in individual cases. Sometimes it is merely informal, but in other cases it is cemented by the banker's taking a stock interest and a place on the board of directors of a corporation. Among the larger banking houses, this custom has become so generally adopted that one firm will frequently refuse to consider financing for corporations which have been definitely affiliated with another.

In the case of the larger originating houses, financial relations with the applicants assume a major rôle. J. P. Morgan & Company established its prestige first as a railroad reorganization firm. Early success with such reorganizations made investors ready to put money in the rehabilitation of railroad properties when their management was turned over to this firm and its associates through a voting trust. By thus becoming affiliated with the management of these properties, J. P. Morgan & Company, with or without large stock holdings in the property, became recognized as the "banker" for the railroad, and often was represented on its board of directors. Personal contacts of great value resulted, so that it became quite unusual for the railroad company to do its later financing through any other house.

The success of such firms as Morgan, and Kuhn, Loeb & Company in railroad reorganization was followed by similar ventures in the industrial field, this time chiefly in the realm of combination rather than reorganization, but with substantially the same results. A long string of companies thus tied themselves up to one or another of the major houses of issue, and the tendency has continued down to the present day. A banker who can once successfully float an issue of a company's securities, especially when this is connected with taking a block of the company's stock as bonus or assuming a place on its board of directors, traditionally becomes affiliated with the future issues of that company. To some extent, this practice has invaded the field of government finance as well, with the result that several European and South American countries regularly do their financing here through their accredited "bankers." Here again houses with a large measure of public prestige are dominant. J. P. Morgan & Company is regarded as the official "banker" in this country of the governments of Great Britain, France and Italy; while Chile, Uruguay and several other South American countries look to the National City Company as their permanent financial connection here. In many of the latter cases, the country seeks to strengthen its own credit standing through such permanent strong banking connections.

When an investment house has established itself in a definitive relationship with a vigorous and expanding enterprise, the result may be that a steady stream of new financing proposals may come to it from numerous subsidiaries and affiliations of the company it originally finances. The banking houses which have affiliated themselves at an early date with the chief public utility holding companies, for example, have over a period of years received a steady stream of new issues from each of these large and complex groups of companies, continually in the market for new capital to meet the rapidly growing public demand for their services.

The personal relations of members of an investment house tend to become widely ramified, and thus lead to new financing proposals. Thus, when an investment banker takes his place on the board of directors of one company with whose financing he becomes affiliated, he is likely to be thrown into contact thereby with business men having numerous other interests which may be good prospects for future financing. Several investment houses have even combed the lists of their security-buying customers for business men who own what are known as close corporations, controlled by one or a few men, and then approached them with projects for recapitalization and the sale of their securities to the public.

2. As the number of investment houses has multiplied in recent years, competition for good issues has become greatly intensified, and several houses have established a special outside organization for bringing business to the firm. In a few cases, this has meant the actual establishment of a branch abroad, equipped to purchase issues; but most branches are devoted to other activities also. It is, as a rule, too expensive to maintain large and permanent branch organizations solely for the purpose of buying securities. More usually, field representatives, known as buyers or negotiators, are sent out to establish contacts and find suitable new offerings. On the other hand, there are a number of semi-independent negotiators, both in the foreign and domestic fields, who go about finding suitable issues and then present them to banking houses. The professional promoter of new enterprises or combinations often works in this way. Compensation takes the form of a fee or percentage usually paid by the banker, while at other

times an allotment of junior securities is the consideration paid.

In the foreign financing field, the independent negotiator and special representative have played a particularly important rôle, for the usual banking connections are not as generally developed in this department of financing. In practice, those negotiators who have succeeded have been men with wide banking and business connections abroad, who have evinced a knowledge of finance and business both in the originating country and in the home capital market. Many of them have also had to have a knowlege of the intricate international legal problems involved, especially in the case of foreign corporate issues, for this is needed even to begin negotiations on a practical basis, before it is feasible to call in outside expensive legal advice.

3. A well-established investment banking house often has numerous contacts with other banks that bring it business. An investment house affiliated with a commercial bank is in an especially favorable position in this respect, since the latter can turn over their clients whenever bank borrowing becomes excessive or large needs for new capital arise. Recently many investment houses have established contacts with financial institutions in Europe and South America which have played an important part in directing the flow of our capital abroad. Many a foreign issue originally went to a European banking house long affiliated with that particular issuer, the American firm being called in later to assure adequate distribution.

The banks also are influential in bringing corporations whose activities are chiefly in the interior of the country to the city investment bankers; and as a result, a series of mutual relationships have grown up which bind banks and investment houses together in a manner that resembles the correspondent relation between banks in different localities.

Relations between banks and investment houses are often cemented when members of the house become directors of banks, as is frequently the case. In fact, the largest originating houses are closely affiliated with the great city banks, constituting financial groups or "interests" of great influence. In addition, banks and investment houses gain a common interest through serving the same large business corporations, organizing investment trusts in common, and exchanging favors, which they are often in a position to do.

4. A certain number of issues are sold through direct application of a company to a banker, without previous acquaintance or other intermediaries, but they comprise doubtless a rather small minority of the total new financing. To a large extent, such direct dealing is restricted to more speculative issues, houses specializing in the latter frequently advertising in the daily newspapers for new security offerings. As a result, a certain amount of suspicion often rests on direct applications by unknown parties to investment banking houses. And when a financing proposal becomes known as one which has been "shopped around" in numerous quarters, this suspicion becomes acute.

On the other hand, many instances are known where desirable propositions were brought directly to the investment house by the vendors. This is especially true for firms which have established a reputation for successful financing in some special and relatively new field, such as chain store, natural gas or airplane manufacture. Then those with meritorious propositions often must approach a banker directly, because of the newness of the industry and the lack of established connections, and houses with a reputation in the field would naturally be most likely to desire and effectively sell a new issue. A rather similar result may be achieved for financing in general by an investment house which has put out in succession a number of highly successful security issues.

5. While most of the securities offered in the New York market are purchased by investment banking houses as a result of direct negotiation with the vendor, large amounts of bonds are regularly sold through competitive bidding. At the present time, the great bulk of municipal issues and some foreign government bonds are sold in this way, and the Interstate Commerce Commission has been experimenting with this method of sale for the railroads, restricting it for the time being to equipment trust certificates.

The arguments advanced in favor of competitive bidding usually are the following:

1. The vendor gets the highest possible price for the issue.
2. By ending special relations between the vendor and individual bankers, more firms become interested in its issues, leading eventually to a wider distribution of its securities.
3. Banker domination is eliminated.

Against competitive bidding the following arguments have been frequently advanced:

1. Bankers withdraw the advantage of special support when competitive bidding takes away the motive they have in supporting the credit of a vendor with which they have been specially identified.
2. The eagerness of competition leads to too high prices for individual issues of securities, causing loss to the bankers and the public, poor distribution and unsound general conditions in the securities market.
3. In adverse times, no bids may be forthcoming.
4. Establishment of permanent financing channels tends to cut the cost of distribution and eventually to lower the price of securities to the public.
5. The strongest banking houses tend to restrict their activities to business they are certain of getting, leaving securities available by competitive bids open to weak and speculative organizations.
6. Investigation is less complete.

In practice, competitive bidding appears to have established itself permanently in municipal finance, where advantages of tax exemption, standardization and the general financial strength of American municipalities make special banking connections less essential. In foreign financing, competitive bidding becomes of declining importance as foreign governments and corporations establish banking connections here, although originally this method of disposing of security issues was rather widespread. Its waning importance was shown when the government of Roumania, in 1927, sought to sell an issue of bonds by requesting bids from 36 banking houses. No response was elicited, although arrangements were made later with an individual banking house acting for an original purchase group.

It has been found that competitive bidding is suitable only where the issue is of a standard variety that can be readily analyzed by a large number of interested houses. Municipal bonds and railroad equipment trust certificates have hitherto proved to be the only important classes of securities which meet these requirements. As the conditions surrounding the operation and financing of railroads, public utilities and other basic industries become more stable and uniform, it is possible that the practice will spread.

6. The great majority of bond houses get a share in new security issues by joining with other houses in forming a distributing syndicate. The operations of such security syndicates are discussed in the following chapter. Invitations to join a syndicate are sent out by the original issuing house, usually a few days before the actual offering. Some study, usually of a cursory nature, is made of the new issue, and then the investment committee decides whether or not to accept the participation tendered. Participations vary greatly in size according to the size of the house and its relation with the syndicate head. If the latter is one of the more important houses of origination, it may be bad policy to antagonize it on future issues by turning down a proffered participation. A house which has done yeoman's service in distributing previous offerings put out by the syndicate manager may seek and get a larger allotment than is first offered to it when a really desirable issue comes along.

Negotiation of Security Issues

From whatever source the proposal for new financing is received, it is turned over to the buying department of the investment house for investigation and negotiation. Where banking relations have been firmly established, negotiation may be a routine matter and take but little time. However, in order to bring out all of the problems which face the investment banker in the negotiation of new issues, this section will outline the steps taken in the study and negotiation of an entirely new security offering, it being understood that the process is abbreviated when additional financing is done for the same client.

When a new financing proposal is first received, a rapid preliminary study is normally made. This study includes for a corporation an analysis of the industry in which it operates, and a study of its financial and other available statistics. From this study, made by statisticians and other experts in the buying department of the house of issue, and often supplemented by a quick check with a bank or other outside source of information, the investment house, usually through an "investment committee" of partners, decides whether or not it is interested. If it is, the house generally tries to secure from the prospective vendor of the security issue a memorandum or preliminary contract, giving it an option on the issue for a certain period of time, thus protecting the house against negotiations with competitors while a more extended and expensive investigation is carried on. Without this option, the issue may be sold to someone else before the investigation is completed, thus causing the loss to the house of effort and money expended.

In making the full investigation of the proposition which follows, the method varies widely according to the type of issue and vendor, as well as its size. One leading house gives the following outline of the facts it seeks in most cases. This outline serves as a check list, and data are sought on as many items mentioned as is feasible.

A. GENERAL AND COMMERCIAL INVESTIGATIONS

(Conducted by the Buying Department)

1. Ownership and management
2. Credit position
3. Location of property
4. Character of products
5. Market
6. Competition
7. Labor conditions
8. Public relations
9. Office analysis of earnings, balance sheet, etc.

B. ENGINEERING EXAMINATION

(Conducted by engineering experts employed by the Buying Department)

1. Description of service or product
2. Valuation of property, taking into consideration the replacement value less depreciation and intangible values such as franchises, processes, patents, good will, etc.
3. Physical condition of the property, including its present condition, the improvements necessary to put the property into first-class business condition and operating efficiency, the policy of the company with reference to additions, betterments and maintenance, the rate of depreciation and the expense and percentage of gross earnings necessary to maintain the property in the most efficient operating condition. Is the property economically and strategically located as to efficiency and economy of distribution—availability of transportation, availability to supply of raw materials, etc.?
4. Present and probable future sources of competition, and the extent to which they do or may effect the status of the company
5. The labor situation, especially the relationship between the management and employees
6. Comparison of earnings and expenses with other similar companies; do they give adequate return on the value of the property? What has been the effect of rates, prices of materials, wages, etc., on earnings?
7. To what extent will money be required for future improvements?

C. LEGAL EXAMINATION

(Conducted by legal experts employed by the Buying Department, usually a well-known firm of corporation attorneys)

1. Has the company been legally and validly organized, and is it currently in good standing with the authorities under which it was organized?
2. Has it all franchise, charter and other rights necessary to enable it to carry on its business?
3. Has it good title to its various properties sufficient for the use to which they are put? To what extent are they subject to any liens, charges or encumbrances which would interfere with the operations of the company or impair the rights of the bondholders?
4. Are all legal papers affecting proposed bond issue, including any contracts, leases and agreements, indenture, the bonds themselves, in proper form?

D. AUDIT

(Conducted by accounting experts employed by the Buying Department)

1. Comparative earning statements and balance sheets over a period of years
2. Comparative statements of charges to maintenance and depreciation

3. Analysis of the accounting system. Is it adequate and sufficient? Have items been charged to the proper accounts?
4. Audit of accounts in detail

The Purchase Agreement

When the full examination is completed, the investment committee or partner in charge of the buying in the investment house reaches a final conclusion. If favorable, the bankers generally send a letter or telegram to the vendor expressing a willingness to purchase the issue on stated terms, including often the price they are willing to pay. This letter thus constitutes an offer to purchase, which may be accepted by the board of directors of the corporation, or an accredited official in the case of a government bond issue. Often final approval must also be secured from the stockholders of a corporation or the legislative body of a government before the purchase can be legally consummated.

When such approval as required has been secured, it is the usual practice to embody the terms of the transaction in a purchase or underwriting agreement, which is often a lengthy and formal document. At other times, the letter from the bankers alone constitutes the purchase agreement. The chief items generally found in a purchase agreement are:

1. A full description of the securities to be issued
2. The price to the corporation, and the method and time of payment
3. Provision for a letter of information from a corporate officer, listing on exchanges and compliance with blue-sky laws
4. Disposition of proceeds of issue, future financing and reports to the bankers
5. The whole transaction is made contingent on finding representations of the company correct as stated

In most cases, the lawyers cannot render a final opinion on the validity of the issue until after the purchase agreement has been signed and the securities, perhaps, sold. In such instances, it is carefully provided in the agreement that the purchase is contingent wholly upon a satisfactory finding of the lawyers in this respect. At times, when the auditors' report is especially complex, a favorable report from them may also be included as a condition for the completion of the deal.[1]

In arriving at the price to be paid for a new security issue, the investment banker is governed by the state of the market and the known preferences of buyers. Like wholesalers in other lines of business, buyers of entire issues of securities must keep in mind that what they buy is to be sold again. Hence, bankers are quick to sense changes in fashions, turning from bonds to stocks and from one industry to another, as tastes of investors vary.

In the case of new bond issues, the terms are determined approximately by the yields of similar securities as shown by market prices. If a similar issue already traded in gives a yield of, say, a little less than 6 per cent, that fact will fix the other terms. A maturity date which is common for the industry—ten to twenty years for the general run of industrials, twenty to forty for basic industrials, and thirty to fifty for utilities—is chosen. Then a coupon rate will be fixed which will permit the pricing of the issue at a point a little under par. Investors, like other buyers, seem to prefer such a price. In part, this reflects the same psychology as underlies the popularity of prices like 98 cents or $1.98 in the general merchandising field—it gives the impression of a bargain price and sounds much more attractive than prices like $1 or $2.[2] Secondly, investors prefer to buy bonds at a discount because in that way they gain assurance that the principal of their fund will not be impaired. Hence, in the present instance, the bond will in all likelihood be a 5½-per-cent issue which will be offered at about 97½.

The price that the bankers will pay will be the expected market price reduced by the gross spread desired. This spread, of course, varies with the type of issue and the state of the

[1] The National City Company canceled a contract to purchase an issue of bonds of a steel company in 1926 when the auditors' statement disproved figures of the company.

[2] This peculiar merchandising practice is said to have been originated many years ago by R. H. Macy & Company, New York department store, to "check up" on sales by clerks through fixing prices which would require getting change at a central desk where sales records were kept.

market. In the case of standardized, tax-exempt municipals, easily sold in large blocks, it may reach barely one point, or one per cent of the par value. It may be over ten points in the case of speculative issues. A place on the board of directors, a stock interest and expectations of future profitable financing may cause bankers to reduce their usual spreads.

In order to determine spreads on security issues on a more or less scientific basis, the application of cost accounting principles is now being advocated. The pricing of new security issues has hitherto been a rather haphazard affair, immediate expediency and practical judgment being relied upon by the investment banker. While cost accounting has made great progress in the industrial and merchandising field, very little has been done in the direction of applying it to investment banking. So large a part of the expenditure of the investment house is of a general or overhead nature, and so little uniformity exists in departmental organization, accounting systems and methods of compensating salesmen—often the main expense item—that the application of cost principles becomes a very complex problem.

A survey made in 1928 revealed that out of twenty typical investment houses in different cities, only one had anything like a complete cost system. Five others had some income and expense analysis by departments, and three made some tentative analysis of income and expense per item sold.[1] Following this survey, the Investment Bankers Association of America set a sub-committee to work out a cost accounting system for the business which would pave the way to the determination of proper price spreads, through pointing out the unprofitable kinds of securities handled which can then be dropped unless a larger spread can be secured upon them. The following data are said by this sub-committee to be desirable for such cost control:

1. Actual Gross Profit of each issue of securities offered for sale. This would be analyzed so as to show for each issue:

(a) Buying Profit (for originations)
(b) Buying Expense (for originations)

[1] See *Proceedings* of the Investment Bankers Association of America, 1928, pp. 143-161.

(c) Underwriting Profit
(d) Banking Profit (when this is not merely a quantity discount)
(e) Selling Group Profit
(f) Loss of Selling Group Profit due to repurchases by syndicate managers
(g) Secondary Profit

Not all of these items would occur in every issue. These figures should be analyzed from the point of view of finding out why the issue is or is not successful, so that buying policies may be based on factual experience in addition to pure judgment.

2. Speculative Profit or Loss of each security issue. This is the differenc between budget selling profit, consisting of the difference between the cost of the issue, plus expenses, and the formal public offering price, and actual selling profit; and when considered with general external economic conditions gives an idea of the risk factor which may be expected in various circumstances.

3. Distribution Cost of Each Issue. This is one of the most important records and, when sufficient information is built up, gives an idea of how many points profit should be allowed for selling costs of various types of securities under various marketing conditions and with various prevailing interest rates. Some issues are brought out with, for example, two points selling group profit at such a price that they are sold practically without effort. In that case, from the point of view of the issuing house, they may be priced too cheap, or the selling group commissions may be too great, or both. It scarcely need be pointed out that if it were possible for the issuing house to establish with scientific precision for various external marketing conditions and interest rates the correct price and the correct selling group commission, the advantage in knowing what to allow for distribution costs in making the bid when buying the issue, and in conserving profits when selling the issue would be enormous. Such a state of precision cannot be hoped for, but many of the factors can be reduced to a definitely known basis so that judgment need not be exercised on so many variables as is now customary.[1]

In the case of stock issues, the price is often fixed at a figure believed most attractive to buyers at the moment. Generally, and especially in the financing of newer promotions, the spread is considerably larger than in the case of bonds, and stock bonuses play a more important rôle.

Practice differs widely in arranging payment for new security issues. In certain instances, the full purchase price is turned over on the signing of the purchase agreement. In other cases, payment is provided for only after a certain

[1] Interim Report of the Sub-committee on Cost Accounting of the Business Problems Committee, *Investment Bankers of America Bulletin*, vol. xvii, pp. 102-110.

period of time—for example, a month—has elapsed, to permit the bankers to sell the securities before having to pay for them. In still other instances, a part of the purchase price is paid on the signing of the purchase agreement, and the balance is payable at stated intervals.

Organization for Security Purchasing

The investment house is gregarious. It does not like to do business alone; the bulk of its operations are done in conjunction with other houses.. There are two important reasons for this. In the first place, there is a desire to share the liability involved in any one transaction, so that, should the position of the specific issue or the general market take an unfavorable turn, or should a sudden panic develop, the house need not be tied up in one or a few big commitments which endanger its solvency. In the second place, when the actual task of selling securities must be accomplished, there is a desire to share the selling effort by bringing in an adequate number of houses with distributing power to assure the complete and successful disposition of the issue within a reasonable length of time.

The simplest form of coöperation in security purchasing is the joint account, in which two firms join to handle a single transaction. Many of the principles underlying the coöperation of three or more houses in what are generally known as syndicate transactions may be seen in simplified form in the working of the joint account. These transactions involve a manager, usually the house which originated the issue, in order to assure centralized control and to prevent more sales being made than are necessary to sell the entire issue.

The essential features of the joint account are brought out in the following typical letter sent by the house originating the business to the one which is invited to join it:

> Confirming our verbal understanding, we have ceded to you an interest of 50 per cent in our purchase, at 90 and accrued interest, of $1,000,000 X Power & Light Corporation 5-per-cent bonds. To facilitate the handling of this Joint Account, we shall act as Managers and keep the records. The offering price of these bonds to the public will be 92 and accrued interest, from which price there will be allowed to either of us on confirmed sales a selling commission of 1 per cent. All sales, however, will be subject

to confirmation by us as Managers, and will be applied against the total obligation of the Joint Account. The Joint Account will continue for a period of two months from the date of this letter, unless sooner terminated, or unless extended by mutual agreement.

Kindly confirm the above as being in accordance with your understanding.

In the above instance, the corporation receives $900,000 for its bonds. The bonds are to be sold to the public for $920,000. If each of the two houses in this joint account sells $400,000 of the bonds, they each make the selling commission of 1 per cent or $4,000 on the bonds sold, and they each take over $100,000 of the bonds left unsold. The profits remaining in the syndicate, consisting of one per cent on the $800,000 of bonds sold, or $8,000 less expenses, is then divided among the two houses.

The operation of the joint account may be further clarified by summarizing the accounting entries as they would appear on the books of the manager, who opens up a special book of account to cover the transactions. Under the assumptions as outlined above, the journal entries would be as follows:

Joint Purchase Account

	Debit	Credit
$1,000,000 of bonds, purchased at 90	$900,000	
$400,000 sold by A at 92 less 1 per cent		$364,000
$400,000 sold by B at 92 less 1 per cent		364,000
$100,000 delivered to A at 90		90,000
$100,000 delivered to B at 90		90,000
Expenses	1,800	
Profit to A	3,100	
Profit to B	3,100	
	$908,000	$908,000

In the joint account outlined here, the arrangements for purchasing the issue through coöperation between the two banking houses are made simultaneously with the selling arrangements. As the size of individual issues increases and the number of houses joining the syndicate expands, the arrangements become more complex, and buying activities tend to become divorced from the selling.

Syndicate practice is far from uniform, new devices and methods being constantly developed to meet changing conditions. Individual investment houses prefer to follow practices they find successful, even if they do not conform to what is done elsewhere. Hence any attempt to classify syndicate practice must be understood as largely an approximation.[1]

In the case of large security issues, the purchase of securities from the corporation by the originating investment bankers may be followed by one or more intermediate syndicates before the issue is finally sold to the public. In this way, the risk involved in carrying the issue is spread over a larger number of houses and the interest of large financial organizations is secured for the issue, thus helping its eventual sale. The formation of each successive syndicate involves, of course, a spread from which profits are divided for the members.

The Purchase Groups

In the case of an issue of moderate size, it frequently happens that a single banking house is willing to take the responsibility of purchasing it entirely. This house then relies upon its known connections to distribute it. However, it is customary for even some of the largest houses to bring one or a few associates into a syndicate; this is called the original purchase group, and shares the liability involved in the contract to purchase the issue from the corporation. Participations in such an original purchase group are on a percentage basis, members of the group being given fractional interests in the purchase agreement or contract that has been entered into with the vendor corporation or government.

The originating bankers and their associates in the original purchase group usually partake in this business on an equal basis as far as price is concerned. One or more of these houses then become the managers of the succeeding syndicates which are formed to carry and distribute the issue. While in the original purchase group participation is arranged on a per-

[1] The Investment Bankers Association of America has sought to summarize the best current practice, and in some degree to advance the cause of greater uniformity in syndicate operation, by sponsoring the volume known as *Security Syndicate Operations,* written under its auspices by Arthur Galston. The student is referred to this work for a more detailed discussion of the whole subject.

centage basis, in the syndicates which follow the general practice is to give participations in terms of stated amounts of bonds. In this case, therefore, participations are arranged for specific blocks of securities, such as \$100,000 or \$1,000,000.

These participations, furthermore, may be either on a divided or an undivided basis. This distinction is highly important, for it fixes the liability of the members. A divided or limited syndicate limits the liability of members to the amount of securities named in their participation, so that, if they dispose of or take over a given amount of securities, should this prove necessary, their liability at the dissolution of the syndicate is limited to the difference between such securities sold or taken over and the full amount of their participation. Thus, a house which has a \$100,000 participation in a divided syndicate, and which disposes of \$95,000 of securities, on dissolution may be asked to take up a maximum of only \$5,000.

In an undivided or unlimited syndicate, on the other hand, unsold securities are divided among the members in proportion to their participations, regardless of the amount of bonds or stock they have sold or otherwise disposed of during the life of the syndicate. In such instances, the final liability of a member of a syndicate may be for a larger amount of bonds than his participation calls for, because of the failure of other members to dispose of their portion. In the purchase syndicate, however, this liability is usually theoretical, since the securities are to be turned over to another syndicate *in toto*. Only when failure is met in the effort to form a selling syndicate to take over the whole issue is there question of further liability.[1]

In the case of large issues, a second purchase group may be formed which is larger than the original purchase group. While desire to share liability may be one factor in forming the purchase group, a more frequent factor is the desire to bring large banking houses into a purchase group which will allow them a larger profit than if they joined only the selling syndicate. Hence, organizations of large distributing power,

[1] The divided syndicate is sometimes called the "western" type, and the undivided the "eastern," since these forms find favor in the respective regions.

and those which can place large blocks of bonds with institutions, are invited to take substantial participations in this purchase group.

The original purchase group generally makes a small profit on the issue before turning it over to the larger purchase group. The latter is then said to take the issue at a "step-up price." Let us assume that a $20,000,000 issue is purchased from the vendor, a foreign government, at 94. It is sold to a purchase group at 95. The accounting journal entries may be summarized as follows:

Original Purchase Group

	Debit	Credit
$20,000,000 of bonds, purchased at 94	$18,800,000	
$20,000,000 of bonds sold to purchase group at 95		$19,000,000
Expenses	8,000	
Profit to original purchase group	192,000	
	$19,000,000	$19,000,000

The expenses mentioned usually involve chiefly legal fees. The profit is divided among the members of the original purchase group, according to their fractional participations as stated in percentages.

The Banking Group

Where a syndicate is formed to take over the securities from the purchase group and turn them over to a distributing syndicate, the name "banking group" is usually used to denote this intermediate organization. The motive here generally is solely to interest large selling houses in the issue by giving them a profit through participation in the banking group over and above what they receive through membership in the selling group. These houses thus acquire a special interest in pushing these securities, since they make not only the commission and profit to which they are entitled as members of the selling group, but also profits on a larger participation which they are accorded in the banking group. Thus, a house which can sell $500,000 of securities may be given a participation of $1,000,-

000 in the banking group, and through this inducement be persuaded to take a greater interest in the issue.

An important factor to be considered by originating houses whose organizations are not nation-wide in the true sense is the need for securing proper distribution in the Middle West, Northwest, South and Pacific coast, where in recent years large buying power has been developed. This can often be done by including in the purchase and banking groups houses well known in these sections of the country, usually leading investment bankers with main offices in the chief city of the area in which its influence is important. These houses are then made "regional distributors," and are authorized by letter to wholesale the issue in their territory up to the amount of their participation. Thus, of a $20,000,000 issue, a Chicago house might be allotted $5,000,000 for the Middle West, the territory being clearly defined. This Chicago house then invites local houses by which it is well known to take a participation in the selling group, thus reducing its own participation in that group. The out-of-town distribution thus gained is often especially desirable because it represents permanent investment to a very large extent.

As the banking group precedes directly the formation of the distributing syndicate, it is customary to provide that it is to continue until the dissolution of the latter. Should anything untoward happen, therefore, in connection with the operation of the selling syndicate, as might well be should panic conditions develop or some other unusual event hold up the sale of the issue, the banking group will be on hand to take over the liability.

The accounting of the purchase and banking groups is similar to that of the original purchase group, as shown above.

The schematic arrangement of an original purchase, purchase and banking group, as above indicated, does not generally occur in practice, although in many individual instances this plan is followed. Instead, all kinds of variations have been developed to suit individual cases. The larger banking houses now often handle issues of well-known companies up to $50,000,000 through the formation only of an original purchase group and a selling group. The less strong an originating house is, as a rule, the more necessary it is to gain the aid of other houses by forming intermediate groups which make a "step-up" profit.

In the case of most municipal issues, bids are made by a large syndicate, rather than by an individual house. This syndicate frequently is identical with the selling syndicate, so that the issue may be offered on the same day as the bonds are awarded, if market conditions are favorable. The small margin of profit militates against the multiplication of syndicates in municipal bond operations, although cases have arisen where one syndicate which acted as both the purchase and selling group, having failed to dispose of the entire issue, sold the unsold portion to a different syndicate in order to rid itself of the balance of the issue and dissolve.

Conditional Purchases

At times when the security market is in an uncertain state, or when the vendor corporation has a weak credit, the sale of securities to the originating house, or the original purchase group, may be made contingent upon the successful formation of a selling syndicate. An example of such a syndicate, which also reveals interesting details of the practice followed in connection with the sale of a large issue of railroad bonds, is given in the following description of the sale of $25,000,000 of 7-per-cent bonds by the New York Central Railroad Company through J. P. Morgan & Company, as contained in the reports of the Interstate Commerce Commission:

> The facts in regard to the sale are briefly these. It was made without competition. Applicant dealt only with J. P. Morgan & Company and accepted that firm's agreement to "*endeavor to form* a syndicate to purchase from ourselves and associates at 97 per cent and accrued interest and offer for public subscription at par and accrued interest." If this endeavor proved successful, J. P. Morgan & Company agreed to buy the bonds at 96.5259 per cent of par and accrued interest, or, in other words, upon a 7.5-per-cent basis. The "associates" mentioned in the agreement were eventually the National City Company and the First National Bank of New York. . . .

The Pure Underwriting Syndicate

It is customary for established corporations to sell their stock issues directly to their own stockholders, rather than to the general public through an investment banker. In many individual cases, furthermore, bond issues, especially where they are convertible, are also offered first to shareholders. Where this is done, the corporation frequently finds it desirable to assure itself that the securities so offered will be taken up by the shareholders through the formation of an underwriting syndicate.

Such an underwriting syndicate consists of a group of bankers which, for a consideration, guarantees the sale of the issue by contracting to purchase, on the same terms as the shareholders, any portion which the latter do not subscribe for. Thus, an issue of $1,000,000 of stock may be offered shareholders at 100. If they take only $400,000 of the issue, then the underwriters' syndicate will take over the balance of $600,000 at the same price. The actual price to the syndicate will be reduced by the commission it receives, however.

Compensation to the underwriters is arranged in two ways. In many instances, a flat commission is paid on the whole amount of the offering. Thus, when the Baltimore & Ohio in 1927 offered $63,242,500 in new common stock at 107½, the underwriting syndicate received a flat commission of 2¼ per cent on the entire issue, regardless of how many shares stockholders took up. As a matter of fact, shareholders took up practically the whole issue, and the commission of $1,422,956 received by the bankers was largely in the nature of an insurance premium paid by the company to cover a contingency —failure to sell the new stock to shareholders—which did not occur.

A second way of arranging compensation for the underwriting syndicate is to fix a small rate of commission on the underwriting of the entire issue, and a higher rate on those shares or bonds which the underwriters must take up. It may be provided, for example, that a commission of 1 per cent will be paid on the entire amount of the issue underwritten, but that a commission of 5 per cent will be paid on any portion of the issue taken up by the underwriters. The first payment is in the nature of an insurance premium, which is to be received even if stockholders take the whole offering. The second payment represents the usual differential between the purchase price and the price of sale to the public of a new security issue.

The underwriting syndicate often restricts its activities to this one function, and therefore includes houses mainly on the basis of their financial responsibility, rather than their ability to sell securities to the public. Hence, when a large portion of the stock or bond offering is not subscribed for by stockholders, a separate selling syndicate may be formed by the underwriters and the issue is handed on to them, at a step-up price if possible.

Inventory Policy

The buying department of an investment house, whether it purchases for wholesale or retail distribution, faces the problem of providing as many securities as can be sold at a profit, without permitting so great an accumulation of unsold issues at any one time as would create a serious problem of inflated inventories.

Sudden changes in business conditions or in the money market may sharply curtail the ability of the market to absorb issues. The large originating houses at such times are often asked by smaller firms and dealers to take back securities sold to them, in order to relieve the latter, with their limited resources, of the necessity of carrying substantial amounts of temporarily unsaleable securities. In the past, it has often proved to the ultimate interest of the large house to oblige the small firms in this respect, for their coöperation at other times in the distribution of securities is thus secured. As a result, the large investment houses have found it profitable to draw increasingly close to commercial banks, which have facilities for carrying them through periods of large inventories with collateral loans at moderate rates, even when the money market becomes unusually tight.

Proposals have been advanced to put the management of the inventory problem upon a more scientific basis through the application of budgeting methods for sales. Based on past performances of salesmen, branch offices and other outlets, the house may work out a monthly sales budget which the buying department must meet in order to satisfy the requirements of the sales department. This requires the closest coöperation between the two sides of the business.

For a fuller understanding of the buying operations of the investment house, it is necessary to have a clear view of the complementary function of securities selling, which is taken up in the following chapter.

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Chapter XVIII

SELLING SYNDICATES AND GROUPS

The Distribution Problem

In the preceding chapter, the process of originating new security issues was traced, and the mechanism by which investment houses purchase and carry these securities pending distribution was described. American investment banking houses very seldom wish to hold issues which they purchase for any length of time. They are in the business of merchandising securities, and a cardinal precept of modern merchandising in general is a quick turnover. Hence, the most important part of the investment banking process is the sale of securities to investors.

Practices connected with the negotiation and purchase of new security issues have not been much changed in recent years. The business of origination is still largely restricted to a relatively small number of firms with wide connections and resources. On the other hand, there has been a profound change in the methods of distributing securities. The great extension of the capital market and the vast increase in the number and kind of agencies serving it have revolutionized the work of security selling.

In considering the distributing syndicate, it is important to note that three distinct and sometimes conflicting aims are striven after. The first is a reasonable and, if possible, large profit to the participants. Secondly, speed is of the essence in successful syndicate operations, for members do not want to have their resources tied up any longer than is absolutely necessary. The longer a syndicate remains open, the greater the risk of unforeseen developments which may interfere with the successful consummation of the sale of the issue to the public. In the third place, the syndicate aims at wide and permanent distribution of the securities as far as possible, both for the satisfaction of the vendor government or corporation, assuring permanent relations with it, and to prevent dissatisfaction among clients by later sharp declines in price due to poor distribution.

The assurance of a profit is itself frequently dependent on the factor of speed. The purchase of securities from the vendor is usually made on terms dictated by the state of the securities market. If it is felt by the bankers that a bond issue can be sold successfully at 95, they may purchase it at 92. Unless the sale is effected as quickly as possible, however, it is quite likely that the market may change and a sale may not be possible at more than 93, leaving perhaps a net loss after necessary syndicate expenses.

In order to protect themselves against such hazards, therefore, the originators of a security issue, and their associates in a purchase or banking group, generally start on the formation of a selling group even before the purchase contract with the vendor has been formally signed. In this way, the distributing syndicate may be completed on the same day that the agreement is signed, and public offering can be made immediately thereafter.

This preliminary work in syndicate organization usually consists in sounding out investment houses and determining their attitude toward such an issue as is proposed. Often the final terms of the offering are modified on the basis of the results of this sounding process. For example, if a 6-per-cent bond issue is planned and security dealers indicate that they cannot easily sell a security without a speculative feature, the terms may be changed to a 5½-per-cent issue with common stock purchase warrants attached.

Choosing the List

The first important step in the actual formation of a distributing syndicate or group is the choice of a list of security houses to constitute its membership. This is a delicate and difficult task, for the best issues of securities may prove failures if backed by a group of firms with inadequate distributing facilities.

At the present time, the chief criterion of the value of an investment house for a distributing syndicate is its ability to place bonds with more or less permanent investors. Formerly, it was common to include houses of financial strength because of their financial responsibility and strong reputation. This is becoming less frequent, however, such firms now being sought mainly for the purchase and banking groups.

Ability to place bonds may be secured by a house in several ways. The most common at the present time is through a corps of salesmen, who have a clientele reached by direct solicitation. In the second place, a large and increasing number of security houses and banks have investment trust or finance company affiliations, with whom substantial amounts of bonds may be placed, thus greatly improving their distributing power. Thirdly, many banks have more or less separately organized securities departments and companies, thus selling securities over the counter to customers of the bank, as well as through salesmen. Commercial banks also buy for their own investment account. Finally, it is not uncommon for investment trusts, trust companies and even large individual investors to be given places on distributing syndicates because of the large amount of an issue they can take.

The chief consideration in the choice of members of a syndicate is, therefore, distribution power. The large originating houses, which have long experience in the capacity of distributing syndicate managers, keep a record of the past performance of security houses and banks which they propose to invite to join new syndicates, and thus are in a position constantly to weed out houses which chronically fail successfully to place bonds and stock allotted them, while increasing participations for those which are successful. A separate card or loose-record sheet is generally kept for each syndicate participant, recording his participation and the record of his success or failure in handling it. A sample of such a card is shown in Fig. 12.

The multiplication of institutional investors in recent years has made it increasingly difficult for the small dealer to hold his own. When the commercial bank, the savings bank, the investment trust and the insurance companies are all getting bonds below the offering price, at what they regard as a "wholesale price" to which they are entitled by virtue of the large-scale buying they do, the small security dealer finds he cannot sell to these worth-while customers at a profit. The Investment Bankers Association is seeking to correct this situation, and at the same time to limit competition in the security business, by publishing lists of authorized dealers who alone are considered entitled to syndicate membership or to dealers'

Name.................................

Address.......................... .... Number of Offices

DATE	ISSUE	PARTICIPATION		SALES	REPURCHASES
		OFFERED	ACCEPTED		

FIG. 12. CARD FORM TO RECORD PERFORMANCE OF SYNDICATE MEMBERS.

discounts. The first published list of authorized dealers, compiled by the investment houses which are members of the association in each part of the country, was distributed in 1929. In describing its purposes, the Investment Bankers Association of America made the following statement:

> It is desirable that all members of the Association conform, in so far as possible and in the territories covered, to the list of dealers in the granting of concessions to dealers and in the offering of syndicate or selling group participations.

In compiling the list, no responsibility is assumed by the Investment Bankers Association of America or any of the Groups thereof with regard to the moral and/or financial responsibility of any dealer listed therein or for any errors or omissions in the list. Several of the Groups have furnished their lists to all members of the Association in printed pamphlet form; and at least three Group lists have classified certain dealers as being eligible to receive syndicate participations and dealers' discounts, and certain other dealers as being eligible for dealers' discounts only. In reproducing the lists in the pamphlet, it was determined, for sake of uniformity and simplicity, that the dealers should not be divided into classes. Revisions of lists will be made by the Groups from time to time.

The list is not limited to members of the Association, but includes all dealers entitled to recognition as such in the opinion of the respective Groups, whether members or non-members of the Association.

The list is compiled for the use of members of the Investment Bankers Association of America only and has been copyrighted.

The security dealer generally understands that he must adopt a consistent policy with regard to the acceptance of syndicate invitations. If he turns down an offer to join a syndicate formed to sell an issue not altogether desirable, he may very possibly be left out of the list of houses invited to join the next syndicate organized by the same underwriting group to put out a highly desirable offering. The leading originating houses universally demand that participants in their syndicates take the good with the bad, as they come along. Only in this way can they build up an efficient security distributing machine of a permanent character.

For the smaller security house without much originating power of its own, a regular place on the syndicate lists of the large originating house is often its most valuable asset. Such a place can be won, however, only by consistently accepting invitations to join syndicates and by proving that participations can actually be placed with investors. This curtails to a certain extent, of course, the ability of the house to run its business solely in the interests of clients, as it means that sometimes securities will be taken which the house, if left to its own judgment, would not care to sell to its clients.

The alternative to joining distribution syndicates or groups for the smaller house is to "sell off the list" of a larger house, and many small dealers and banks do so as a regular thing. This is accomplished by securing the printed offering list of an issue house and offering to sell securities from it at the prices therein stated. The house whose offering sheet is used then allows a special dealers' discount of, say, ½ per cent on such sales.

A final consideration in connection with the choice of houses in the formation of a selling syndicate or group is the number to be included in the invitation. This will depend on the general state of the market and, more specifically, on the reception investors are expected to accord the issue. If there is uncertainty as to this reception, it is customary to invite houses whose aggregate participation will substantially exceed the amount of the offering as, under the circumstances, many participants will be able to place only part of the bonds they ask for. In the case of a larger issue, several hundred houses will be approached. Thus, in the New York Central issue of $25,000,000 referred to in the preceding chapter, a total of 428 houses were invited to join the distributing syndicate. In other large issues of recent years, upward of 1,000 houses have been included in one distributing syndicate.

Letter of Invitation

When the list of prospective members has been prepared, the next step in the formation of the selling syndicate is the sending out of the invitations to participate.

The usual form of invitation states that the managers of the syndicate have ceded to the participant a specific amount of bonds or stock. This letter is frequently preceded by an informal feeler inquiring whether or not the dealer is interested in the issue—an inquiry which may be made by telephone or, for out-of-town dealers, telegram. Personal calls may be made on important houses, or on those with whom close relations have not been established, by salesmen who then engage in what is called "wholesale selling." Where such preliminary testing has not taken place, the letter of invitation is worded to say that the managers merely "offer" a certain participation, and this must then be formally accepted or refused.

Another method is to send out a general invitation with a descriptive circular to a long list of dealers, asking them to advise the managers what participation they desire. The managers then allot subscriptions according to their judgment. This method is not as certain as that of specific allotment to each member, and therefore is not as commonly used. When the security market is in particularly bad shape, the syndicate managers are sometimes forced to give merely options to participants, who then try to make sales.

As security-selling syndicates become increasingly nation-wide in scope, it is necessary to use telegrams and the long distance telephone in order to obtain the proper speed in the completion of the arrangements. Hence, the letter of invitation, especially for the out-of-town house, now takes the form of a telegram concisely summarizing the terms of the issue and requesting the prospective participant to make an immediate reply as to his willingness to take a specific participation. This often means that the out-of-town house must make quick and sometimes ill-considered decisions.

Types of Distributing Syndicates

Three chief forms of distributing syndicates are in general use at the present time. These are the limited liability or divided syndicate, the unlimited liability or undivided syndicate, and the selling group.

The limited liability or "sell out" syndicate, which is in greatest favor for larger offerings, limits the liability of each participant to the amount of his participation. If the participant can sell securities equal to the full amount of his participation, all liability ceases and he is entitled to his *pro-rata* share of the profits of the syndicate on its termination. On the other hand, if sales are below this amount, then he must take up the unsold balance unless other participants can sell more than their participations.

In the undivided syndicate, which is of waning popularity, each member is compelled to take up, on the termination of the syndicate, his *pro-rata* share of unsold securities, even if he has oversold his original participation. This type is unsatisfactory because of the uncertainty in which it shrouds the exact liability of syndicate members in taking up the unsold portion of the issue. Its great advantage is that it will induce large wholesale security houses, banks without distribution facilities, and other strong institutions to join the syndicate and lend their names to the issue, without assuming a definite obligation to dispose of a fixed block of securities. The current practice is commonly to give such institutions places only on the original purchase or banking groups where they assume no selling rôle, and the distributing syndicate can then operate on an undivided basis.

The third type of distributing syndicate is the selling group, which has gained greatly in popularity during the last few years. Members of a selling group are relieved of all liability to take up unsold bonds, such liability falling back on the original purchase or banking groups outlined in the preceding chapter. A selling group is formed by invitation of the originating house or a purchase group, which invites dealers to subscribe for securities at the public offering price less a special selling commission which is allowed on sales made by them. The selling group plan for security distribution was first widely used with issues involving a small margin of profit, giving little opportunity for splitting the differential between the original price of the issue to the vendor and the public offering price among several successive syndicates. It has become increasingly popular in all kinds of security offerings, because it permits the addition to one selling group of an indefinitely large number of houses of all sizes which feel freer to take a participation in the issue because no liability for any unsold portion is assumed. A number of important houses now use the selling group method almost exclusively.

The operation of the selling group is relatively simple compared with the older distributing syndicate. Hence, a full explanation will be given first of the latter, after which a *résumé* of selling group operation will be made.

The Syndicate Agreement

The operation of a distributing syndicate is governed by a general agreement signed by the members and the manager. This agreement varies widely in form and content. It is generally a simply-worded and concise document, but experience has caused the insertion of a number of provisions to prevent the development of abuses in operation. Sometimes the letter of invitation and syndicate agreement are one and the same document.

The chief points in the syndicate agreement governing its operation, as usually devised, are the following:

1. Description of issue
2. Commissions
3. Method of handling subscriptions
4. Method of handling repurchased securities
5. Method of carrying unsold securities

In individual cases, any other provisions are included as found necessary.

1. *Description of Issue.* In order to avoid later misunderstanding or complaint, the full name of the issue and the amount should be clearly stated at the head of the agreement. Also, the price at which the syndicate is to buy the securities must be clearly indicated, as well as whether or not the managers and their associates are making a prior profit as the original purchase or banking group. Finally, it should be indicated that the securities are being offered "when, as and if issued and received by us," and "subject to the approval of counsel." This will cover those unusual but real contingencies when the transaction is not completed for one reason or another. If the securities are not actually delivered, the syndicate member or purchaser may sue for damages unless this protective clause is used, thus making the contract conditional.

2. *Commissions.* The difference between the buying price of the issue and the selling price to investors is generally divided in three parts among the members of the syndicate. First, a commission is allowed to syndicate members on sales of securities within the amount of their participation. Secondly, an additional commission is allowed to those members who sell in excess of their allotment. Lastly, the balance, if any, less expenses and all charges, is divided among the members in proportion to their allotment, as profit from the transaction.

To give a concrete example of how this is done, let us say that an issue of bonds is purchased by a distributing syndicate at 94, and that it is to be sold to the public at 98. The syndicate agreement might be worded as follows on the subject of commissions:

"The offering price to the public will be 98 and accrued interest. Participants, including ourselves, will be allowed a selling commission of 1½ per cent on sales confirmed by us, of which ¼ of 1 per cent may be reallowed to investment dealers, banks and insurance companies. Any participant to whom sales may be confirmed in excess of 100 per cent of the amount of his participation will be allowed an additional commission of ½ per cent on such additional sales. Bonds will be delivered at 98 and accrued interest, the selling commission being payable when the accounts of the syndicate are settled."

The reason why commissions are withheld until the termination of the syndicate is that deductions from such commissions on account of bonds resold by investors and repurchased in the open market by the syndicate manager are to be made.

The oversales commission—in the above case, ½ of one per cent—is designed to stimulate selling effort by the members of the syndicate. In many cases, this additional commission is considered a charge against the balance of profits of the syndicate, being regarded as an expense. In other instances, it is charged against the selling commissions already allowed participants who have not sold their full allotment. Thus, if A and B are both allotted $100,000 of bonds, and A sells $150,000, he will be entitled to a selling commission of 1½ per cent on the first $100,000 and 2 per cent on the remaining $50,000 of his sales—$2,500 in selling commissions in all. If B sells $50,000 of bonds, he will get 1½ per cent on this amount, or $750, from which will be deducted ½ per cent on the remaining $50,000 of his allotment, or $250. This will leave him $500. Under this arrangement, the balance of profits in the syndicate would be divided according to the size of the participation, so that A and B would share equally in it. Those who do not sell as much as they undertake are thus penalized to the extent of the additional commission paid the houses which sell more than is allotted to them.

3. *Method of Handling Subscriptions.* It is important to note that acceptance of the invitation to join a syndicate does not constitute a subscription to the issue, but merely assures

the house that it will have a share in the syndicate profit, or loss, which results. Hence, it becomes necessary for the members of the syndicate to subscribe for the bonds or stocks, as the case may be, to the extent of the actual or prospective demand from their clients.

It is common, though by no means universal, to give the syndicate members an option to "draw down" or purchase a certain part or the whole of their commitment before the general offering. In the case of new bond issues, it is said that the participant has "firm bonds." These "drawn down" bonds can then be used to confirm sales to customers of the house. If any additional bonds are desired over and above the amount subscribed to on a firm basis, the managers must be informed. Where no firm purchases are allowed the participants, then all subscriptions are subject to allotment.

The manager handles the allotments on subscriptions according to his discretion, but certain rules are generally followed in practice. Subscriptions are seldom handled according to the time of receipt, as this favors near-by houses at the expense of out-of-town members and is not necessarily conducive to the ultimate aim of the managers—wide and permanent distribution of the issue. Allotment on a percentage basis is usually made on all subscriptions in excess of the participation, with preferential treatment for smaller subscriptions and for houses known to have effective distribution facilities.

In subscribing for promising issues of securities, individual houses often over-estimate their own selling ability or that of the other members of the syndicate, and pad their subscriptions in the expectation of small percentage allotments. Hence, by reserving the right to handle subscriptions in their discretion, the managers are in a position to discriminate against houses which are believed to be padding, for such firms may later request to be relieved of part of their commitment, a step which is rather common when the security market takes a sudden turn for the worse. On the other hand, syndicate participants should not confirm orders to their clients in excess of the firm bonds they "draw down," as small percentage allotments may mean that they are short of the bonds and may have to buy them at a premium in the market.

In order to "take care of" houses which subscribe for bonds in excess of their selling ability, the practice of intertrading among syndicate members has developed. This permits syndicate members to trade among themselves, so that a house with excess orders may take bonds from another firm which receives an allotment larger than needed. In this way, the temptation to throw excess bonds on the market is removed, and a better final distribution is assured. Sometimes the manager will endeavor to readjust the position of different members of the syndicate after the subscription allotment is made by approaching members and asking them to turn over unsold bonds, "without prejudice or penalty to themselves," which are then taken over by the manager or other houses able to place more bonds for final distribution.

A final method by which syndicate members may subscribe to bonds is to "withdraw" their participations. In the usual case, bonds which are "withdrawn" are bought and paid for by the member before public offering at the syndicate cost price, plus ½ of one percent to allow for expenses. When a participant withdraws his participation, he is released from all further liability, except that it is distinctly understood that he will not dispose of his securities until after the expiration of the syndicate agreement. To assure this, the manager often retains the securities until after the syndicate expiration date.

Withdrawn participations are different from the "drawing down" of "firm bonds." The former eliminates the participant from the syndicate; the latter means that he retains his proportionate interest in it, but is allowed to purchase bonds at the offering price less selling commission up to a stated fraction or the whole of his participation. A withdrawn participation puts the syndicate member in the same position as a member of a selling group.

4. *Handling Repurchased Securities.* The distributing syndicate normally assumes responsibility for maintaining the market quotation on the security it distributes. In order to accomplish this result, the syndicate manager stands ready to repurchase securities ostensibly sold by clients of participants, which find their way into the open market.

In order to fix the liability of the several syndicate members to repurchase bonds which the manager buys in the market, a careful record is kept of the numbers of bonds delivered to different participants. When these bonds are repurchased at or below the offering price, the managers then expect to redeliver these bonds to the participant or to cancel the selling commission allowed them on their sale. To accomplish this object, a provision along the lines of the following clause is generally inserted in the syndicate agreement:

"Syndicate participants agree to repurchase at cost to the syndicate such bonds sold by or through them as may be offered in the market during the life of the syndicate at or below the public offering price, and have been repurchased by us as syndicate managers. This agreement applies even though bonds against such purchases may not be delivered until after the date of expiration of the syndicate. We may, in our discretion, withhold the selling commissions which may have been due them on such bonds in lieu of actual delivery."

The option of canceling the selling commissions is retained so that the managers may themselves keep or turn over to another participant the repurchased securities, in case no confidence is felt in the selling ability of the house with which they were originally placed.

In the case of a new issue of securities not previously outstanding, the trading account established by the managers for the purpose of maintaining the market price during the life of the syndicate will have no securities left on the termination of the agreement. The reason for this is that all securities repurchased will have been redelivered to the participants who originally received them, or to others after the selling commissions have been canceled. However, if the new offering is part of an already outstanding issue, the trading account will naturally have to buy a substantial block of the security from old holders, and this cannot be returned to any of the participants. They are distributed *pro rata* to syndicate members, although the agreement generally provides in such cases that the maximum liability to take up securities from the trading account shall not exceed a certain percentage, say 10 per cent, of the amount of the participation.

5. *Method of Carrying Unsold Securities.* When the securities are not immediately taken up by the public and the syndicate must carry a large amount of the issue for some time, the problem of financing arisès. Obviously, it is not desirable to tie up much capital in a slow-moving issue in course of distribution. Therefore, in so far as possible, the unsold part of the offering is used as collateral for a bank loan.

The syndicate agreement describes the way in which unsold securities are to be carried pending distribution. Two chief methods are in use. The securities may be distributed *pro rata* to participants in the syndicate, who then make their own arrangements for carrying them, or they may be carried *en bloc* by the managers for the account of the syndicate. Often the managers retain the option of using either method.

If an issue is being carried by members individually, the syndicate manager may deliver to each at the date of offering his full participation. As securities are sold thereafter, the manager permits their release against such confirmed sales. On the other hand, where the syndicate manager arranges collateral loans for syndicate account, the copies of the syndicate agreement signed by members constitute good additional collateral for the loan. The interest paid the bank on the loan becomes a syndicate expense, and is deducted before arriving at the profit to be distributed among the participants. The interest or dividends received on the securities while they are being carried is part of the syndicate income.

The length of time during which securities will be carried on syndicate account depends on the success of the original offering and the life of the syndicate. At its expiration, the unsold securities are distributed among the participants, so that the loans are then rearranged by them for their own sole account in any case. It is only in less successful issues that the carrying period on syndicate account will be as long as a month for large amounts of securities.

The Selling Group

In the case of the selling group, the process is greatly simplified. The members of the selling group are expected to take up only so much of the issue as they subscribe for and have allotted to them. The stated selling group commission, sometimes several points, is retained by the syndicate manager frequently until the expiration of the selling group arrangement, or until the purchase group which carries the liability of selling the issue is dissolved. At that time, the commissions are paid over, after deductions on account of repurchases in the open market of securities subscribed for by members of the selling group. Members of the selling group are often offered a fixed amount of the securities on a firm basis, so that they can immediately confirm sales to their customers, and they can then make further subscriptions on an allotment basis.

Where the selling group method is used, no formal syndicate agreement is necessary, as no liability is involved. The trading and carrying functions are both performed by the originating house or group. Where securities sold by members of the selling group are repurchased in the effort to hold up the price of the issue on the open market, the selling commission is withdrawn and retained by the purchase group. The expenses of the issue may be deducted from the selling group commission. Thus, if the purchase group turns over an issue at 97 to a selling group with a gross selling commission of 2 points allowed, the selling group letter may provide that a fixed amount of ¼ of one per cent shall be deducted for advertising, legal expenses, etc., making the net selling group commission 1¾ per cent.

The selling group terms are generally all contained in a letter which may assume the following general form:

"We are forming a Selling Group to offer at 100 and accrued dividends $10,000,000 of the above preferred stock.

"On sales confirmed to members of this group, we will allow a commission of 3 per cent, out of which ¼ of one per cent may be reallowed by members to dealers. Expenses incurred in connection with the purchase and sale of this stock will be deducted from this selling commission, such expenses not to exceed ¼ of one per cent in any event. Deliveries will be made at 100 and accrued dividends, less ¼ of one per cent on account of expenses, the selling commissions being payable at the termination of the account, which will be 60 days from the date of this letter, unless terminated sooner in our discretion. This commission is not to be paid on stock delivered to you and repurchased by us in the market at or below the offering price.

"We have reserved for you $25,000 of this preferred stock, provided acceptance is received by us on or before noon on June 15. All orders in excess of this amount of preferred stock will be subject to allotment by us, the basis of which will be entirely in our discretion."

Operation of the Distributing Syndicate or Selling Group

We have so far considered the factors involved in choosing a syndicate list, the major items in the syndicate agreement, and the forms which the underwriting syndicate or selling group may take. We shall now discuss a number of practices which are followed in the operation of the typical distributing syndicate or selling group of the present day.

In the operation of the syndicate or group, the manager has supreme power within the limitations of the agreement. In order to remove any doubt on this score, a paragraph is usually in the agreement which provides that the managers "shall have full power and authority to act in all syndicate matters," without any obligation "except for want of good faith." In the event of a default by a participant, the managers further reserve full right, as a rule, to substitute another house, or to sell the securities at the best price obtainable. If damages are suffered through such default, which is frequently the case, the manager may sue the defaulting house and, failing redress, charge the loss, including legal costs, as a syndicate expense.

After the important but routine details connected with the formation of the syndicate or group have been completed, the manager must be ready for the public offering of the issue. The first important task in this connection is the preparation of the offering circular.

In practice, the bankers often seek to reduce to a minimum statements which constitute direct representations by them. Instead, the bulk of the information is represented as contained in a letter from the president or other executive official of the vendor government or company. Provision for such a letter, therefore, is introduced into the purchase agreement. Furthermore, bankers endeavor to protect themselves further against liability by some such disclaimer as the following:

"All information given herein is taken from sources which we regard as reliable, but in no event are the statement herein contained to be regarded as representations by the undersigned."

The legal liability of bankers on account of statements made in the offering circular has not as yet been definitely determined. In one case which has been pending before the courts for years, misstatements, allegedly made in good faith, were held to involve the liability of the issuing house, but final adjudication of this case has not been had at this writing. It involved the sale of an issue of $5,000,000 of oil bonds on properties shortly afterward found to have only nominal value. The bankers were held by the lower courts to be liable for the full damage incurred. In another case, where an issue of coal bonds was made on information subsequently found by the bankers to be erroneous, voluntary reimbursement of the purchase price was made to buyers of the issue by the originating house, which absorbed the entire loss.

Practices connected with the preparation of the security circulars have been subjected to considerable study and criticism in recent years by the Investment Bankers Association of America. The general use of disclaimers and the tendency to include only favorable information in offering circulars have been frequently criticized by committees of that body. Finally, in 1929, the association began the practice of issuing specifications of information regarded as necessary for circulars for each important type of security. Furthermore, provision is made for quick action against members who violate these standards, complaints being received by the chairman of committees of the association devoted to the different classes of securities and then turned over by them to the Association's Committee on Business Conduct. The principles governing circular preparation have been adopted by the Board of Governors of the association as follows:

1. That neither the Board of Governors directly nor any committee has any intention, now or until members are otherwise advised, of super-

vising in any way the acts of members with respect to circulars *prior* to the issuance thereof.

2. That the Board of Governors has no desire to regulate with respect to what kind of a security members of the Association shall sell, *i.e.*, whether a high-grade or a speculative bond or stock, or any security which might be graded between these two extremes.

3. That the Board of Governors believes it is the duty of members to use care that adequate and accurate information in the sale of securities be released in a way that such information cannot be deemed to be misleading.

4. That when, in the limited number of instances which may occur from time to time, it is not practicable to release complete information in circulars, members making such offerings should see that all additional requisite information is made available at the time of offering through statistical data, annual reports, manuals or other media, to the end that an investor, if so disposed, may analyze the security offered. In other words, it is simply desired that an investor, for himself, shall be able to ascertain readily what character of investment he is asked to purchase.

5. That until otherwise directed by the Board of Governors, each securities committee of the Association, in the class of securities under its supervision, has the responsibility of reporting each year to the Board of Governors (or, if directed by any executive officer of the Association, direct to the Business Conduct Committee) any alleged violation of an established principle.

The circular is generally given wide distribution, the managers printing them in large numbers and permitting all syndicate members to put their own names at the bottom for distribution to their clients. The advertisements of the issue printed in the newspapers on the day of offering contain the essential facts in the circular, along with the names of the leading houses in the syndicate, to add to the prestige of the issue.

Another preliminary task of the manager is to see that regulations governing the sale of securities in the several states have been compiled with. The complex subject of blue-sky laws, as these legal regulations are called, is discussed in Chapter XXII.

The Offering

Having formed the syndicate, completed the agreement and prepared the circular, the foundation is provided for the actual offering. In the case of larger issues, extensive external preparations are undertaken at the same time that these necessary and complicated internal steps are being consummated. Advance publicity of a favorable nature is spread about. Often, two or three advance "news releases" are sent out through the financial agency which is to handle the advertising. These releases tell of the forthcoming issue, and give some pertinent details. The banking house or the agency may have prepared literature concerning the industry or country, seeking to build up favorable public sentiment in preparation for the issue.

In choosing the actual day of offering, it is good practice to put the issue on the market as soon as possible after arrangements are completed, to avoid the possibility of unforeseen untoward circumstances. On the other hand, temporary congestion in the security markets, the occurrence of an unfavorable event or any other circumstance which seems to make delay advisable, would act to hold it up. The managers retain full discretion on this score, and participants who actually sell securities before the formal offering date are guilty of the practice of "beating the gun."

Offerings in most cases are made in the morning, although in individual instances an issue may be formally offered in the afternoon. Municipal bonds are frequently placed on formal sale as soon as awarded, which may be at any time through the day. In general, however, the managers receive subscriptions for the issue at the opening of business on the offering date chosen. In the quaint language of finance, which originated in the days when subscriptions to new issues of securities were received in the public rooms of taverns or coffee houses and inscribed in big recording books, the process of making the formal public offering is called "opening the books." When the books are opened, the managers accept subscriptions to the issue, subject to allotment, from both participants in the syndicate and outsiders. The privilege is always retained "to reject these subscriptions in whole or in part," and in the discussion of the underwriting agreement above it was seen that syndicate members generally can get securities up to their allotment, and subscribe to additional securities if they can get orders. Outside subscribers, therefore, will not have much prospect of getting a share in the issue if the demand for it is heavy.

The managers also reserve for themselves the right to close the books in their discretion. If the demand for the issue is very great, the books may be closed immediately on opening, and announcement is made that the issue has been over-subscribed. Where the results are not good, the books may remain open for weeks and months. In fact, they may never be closed, the unsold bonds being distributed to members of the syndicate on its expiration date. It is understood, of course, that announcement of over-subscription does not by any means indicate that the entire issue has been placed with investors. Members of the syndicate and other dealers place the orders. In many cases they may be padded, and also, because of the need for haste, many of these subscriptions are made blindly before there has been an opportunity to check up on the actual demand for securities among the clients of the subscribing house. Hence, over-subscription means over-subscription by dealers, who then still face the task of making a distribution to the investing public. It is for this reason that the Investment Bankers Association of America has objected to the use of a statement in the offering advertisement to the effect that the entire issue has been sold when, as a matter of fact, subscriptions have come in the main from investment houses who still have before them the task of selling these securities to investors. In several instances, houses have replaced "all sold" statements on the offering advertisement with a new form of announcement that "orders have been received from dealers and others for an amount of these securities in excess of the offering."

The problem of allotting securities against subscriptions where there has been an over-subscription is faced not only by the managers, but also by each investment house as between its own clients. The practice frequently followed is to have a conference of the salesmen, at which old customers and large buyers of securities are given special consideration, while the effort is also made to satisfy as fully as possible orders for small lots because they are considered to represent a *bona fide* investment demand.

Payment by Investors

Subscriptions are accepted and confirmed in the usual case without any cash payment being made. It is one of the outstanding characteristics of American syndicate practice that orders for new issues are taken at the time of offering and confirmed shortly thereafter, while actual payment against the delivery of temporary securities representing the issue is not required for a period averaging about two weeks.

This custom is largely a result of the speed with which such operations are carried out. No time is allowed for the advance preparation and distribution of such securities, and so delivery cannot be made. Furthermore, it is felt that investors should be given a little leeway before being asked to turn over the full cash purchase price of the purchase. Nevertheless, this custom of delaying the payment encourages speculators to "take a ride" by buying the securities in the hope of selling out at a scalping profit before the date of payment. In some quarters, the remedy has been proposed of requiring a down payment of, say, 10 per cent with the order, but this has not as yet been adopted to any extent.

On the date of payment, temporary securities are delivered against the cash payments of subscribers. It usually takes six months or more to prepare permanent engraved certificates of bonds or stock, especially of the former, with their coupons. Hence, it is common practice to deliver an interim receipt, signed either by the syndicate managers, or a bank or trust company acting as depositary for the syndicate funds. This receipt is negotiable and represents the final securities in all transactions until they are issued.

The receipt of the manager of the syndicate is termed an "official" interim receipt. When the funds paid by the investor are not earmarked in a bank account or with a trustee, the Investment Bankers Association has ruled that the evidence of payment shall be called a prepayment receipt. It has urged that interim and prepayment receipts be issued as seldom as possible, and that temporary certificates or bonds be issued instead by the vendor corporation or government, to avoid confusion and danger of loss to the investor.

Syndicate Abuses

A number of practices have developed in the operation of distributing syndicates and selling groups which are not strictly in accord with the terms of the agreements or the intentions of the managers. In certain instances, these practices constitute abuses which will probably be eliminated as remedies are developed. In other instances, these deviations arise from the force of circumstances, and will more likely become recognized as necessary and thus be incorporated eventually in the syndicate agreement, or accepted as ethically correct practices.

The most important series of abuses is connected with the "shading" of the agreed offering price of an issue by participants in the syndicate. If the securities are not moving at a satisfactory rate, the participant in the syndicate may share his profit with his client by reducing the price. This sometimes takes the form of offering the issue at an institutional discount to those not properly entitled to such rebate. Such price-cutting is stimulated by ill-considered large participations in a syndicate resulting from the speed with which decisions must be reached, or by keen competition among investment houses eager to curry favor with large investors.

A more subtle way in which price-cutting is often carried out is through the practice of "over-trading," or accepting other securities in exchange above their market prices. This practice is especially common because salesmen can thus sell the new issue and get the commission, even if the customer has no ready cash for further investment. Although frequently specifically forbidden in the syndicate agreement, effective methods to halt this practice have yet to be devised.

The establishment of a trading account through which securities offered in the market at or below the purchase price are bought in by the managers constitutes a danger to price-cutting practices. If bonds or stock, as the case may be, are sold below the offering price and are repurchased by the managers, the participant must take the security back at cost, although he had sold it at a discount. This means that he suffers a loss equal to the discount, plus selling cost. In order to avoid the danger of such resales during the life of the syndicate, the buyer at these reduced prices must give assurance that he will keep the securities at least during the life of the syndicate. This is termed a purchase "investment guaranteed." As a result, when new offerings do not meet with much success, there grows up an "investment guaranteed" market in which the issue is privately offered below the original offering price, always with the understanding that securities sold in this way will not be thrown back upon the market for a period of 60 or 90 days, or sometimes six months. Dealers outside the syndicate may obtain securities in this way at the full selling commission, and are able openly to sell them profitably at below the public offering price, as these outside dealers are not subject to the terms of the syndicate agreement. Where the issue gets a good reception, however, no "investment guaranteed" market exists, or such bonds as are available on this basis are offered at only the regular ¼ per cent dealers' discount.

Prevention of the price-cutting abuse is sought in the syndicate agreement by provisions permitting the cancellation of the participation of the offending house by the manager. However, since these abuses are most marked where the public response is poor, such cancellation is quite desirable from the viewpoint of the offending house. Hence, the more effective cure is publicity for houses which regularly and willfully violate agreements, so that they can be debarred from future syndicate participations. The Investment Bankers Association of America, which has recently spent much time and labor in an effort to improve syndicate practices, is coming to rely upon reporting of these violations as a cure for them.

A second group of abuses is connected with the practice of "beating the gun," or endeavoring to sell the issue before the date of public offering. The members of the purchase group, and especially the managers, are in a position to give clients advance information concerning the issue, and thus to secure orders before smaller dealers can find out about it. The result is that clients tend on an increasing scale to do business with the larger houses. The spread of advance information concerning a new issue cannot be prevented as a rule, especially where preliminary publicity is desired. But syndicate managers and other members of the purchase or distribution group sometimes accept subscriptions and even make firm sales, thus putting certain clients on a favored basis and getting an advantage over those houses which wait for the "firing of the gun"—the official offering day. Managers at times make this situation worse by making firm allotments of securities to favored participants within the syndicate, who thus have an advantage over other participating houses, since the favored firms are then able to confirm sales well in advance of the offering date.

Winding Up the Syndicate

In order to permit the adequate distribution of the issue, the usual syndicate is given a life of one or two months in the original agreement, while the manager has the right to terminate it sooner or to extend it, as circumstances require. If the issue is well taken, the syndicate may be dissolved as soon as delivery of interim receipts has been effected and payment received. On the other hand, an unsuccessful syndicate may go on for months, and at the end there may be a large undistributed block of the securities remaining to be delivered to the members.

When the market suffers from too many issues, or when prices are declining for other reasons, the maintenance by the syndicates of quotations on new issues gives them an artificial level of values. In such cases, the public tends to lose confidence in all new offerings, and they necessarily fall off in volume. Often this happens at a time when fundamental conditions in the security markets are favorable. In order to avoid such situations, it is considered good practice to shorten the life of bond syndicates and permit the trend of prices to take its normal course as soon as feasible. In several recent syndicates, this has been done by dissolving within three or four weeks syndicates which have not succeeded in placing the issue fully. Investors are expected to gain greater confidence in new offerings if there is less artificial control of the market after issuance, and there will be less fear of a sharp drop in price on the expiration of the syndicate because of "dumping" of bonds by those unable to carry them further.

Another practice sometimes resorted to by less successful syndicates, especially in municipal issues, is to form a "secondary" selling group, which takes over from the original syndicate the unsold balance of the offering. In this way, extensive "dumping" of such securities is prevented. The new group, including houses not in the first syndicate, puts new organizations to work in selling the issue, and is expected to hasten its distribution. The bonds are usually turned over at cost by the first distributing syndicate.

After the termination of the syndicate and the delivery of the unsold securities and selling commissions to the participants, the balance of profit in the syndicate is distributed *pro rata.* This balance is reduced substantially by the expenses of the syndicate. The chief items of expense are counsel fees, advertising of the issue, printing of the circulars, interim receipts, telegrams and mailing expenses which loom quite large in good-sized syndicates, listing fees where this is undertaken and the vendors do not agree to pay the cost, and any loss in the trading account which may be incurred. In the New York Central bond syndicate already referred to, the Interstate Commerce Commission discusses the distribution of the proceeds as follows:

The entire cost to the applicant of marketing the issue was the difference between the par value of the bonds and the sale price to J. P. Morgan & Company, this difference being $868,525, plus small amounts for taxes, legal services, and the engraving of the certificates. J. P. Morgan & Company received as syndicate manager $118,525, which was divided with its associates, and out of which it paid certain clerical expenses, but none of the other expenses of the syndicate. The syndicate members who placed the bonds with investors received from the syndicate for such services a commission of 1.5 per cent on all sales within the amounts allotted to them, and a commission of 2 per cent upon sales in excess of the allotments. After deducting these commissions and the expenses of the syndicate, the portion of the $750,000 remaining was distributed to members of the syndicate in proportion to their allotments. This profit amounted to about 1.1 per cent. Out of the 403 syndicate members, 26 sold no bonds. The distribution of the $750,000 is shown in the following table:

Gross profit of 3 per cent	$750,000
Straight selling commission, 1.5 per cent ($375,000) on $25,000,000; Extra selling commission, 0.5 per cent ($50,130) on $10,026,000	425,130
Gross profit less commissions	324,870
Legal expenses, advertising, etc.	50,000
Net profit, or 1.09948 per cent of $25,000,000	$274,870

It appears that the main items of expense comprising the $50,000 were approximately $27,000 for advertising and $15,000 for legal services.

In keeping the accounts of the syndicate, the managers generally keep five important accounts. The first is the purchase account, which is debited with the securities at cost to the distributing syndicate, as well as with expenses which occur. It is credited with the proceeds of the sales of the securities. Where these proceeds are larger than the cost plus expenses, there is a credit balance which constitutes the profits of the syndicate. The purchase account is thus in effect the final or summary profit and loss statement of the syndicate. For the $25,000,000 New York Central issue, the purchase account, summarized, would have been as follows:

Purchase Account

$25,000,000 bonds purchased from J. P. Morgan and associates at 97	$24,250,000	Transferred from sales account	$24,574,870
Syndicate expenses	50,000		
Profit for participants	274,870		
Total	$24,574,870	Total	$24,574,870

The sales account is credited with the gross proceeds of the sales of securities as confirmed to participants, but is debited simultaneously with the sales commissions allowed to participants. The difference between the gross proceeds and the sales commissions allowed participants is the net proceeds of the sales, and is transferred to the purchase account. The syndicate expense account is debited with the expenses as they occur, and the balance is transferred to the debit side of the syndicate purchase account.

The trading account is formed only where the managers must go into the market to buy securities in order to keep the price up during the life of the syndicate. It is not needed as a rule where the public response to the issue has been exceptionally good. The trading account is debited with securities purchased and credited with the same amount when they are turned over to the member of the syndicate to whom originally delivered. If there is a loss, there is an excess debit balance which is transferred as an expense to the purchase account. Such a loss may arise when, for one reason or another, these securities cannot be delivered back to the participants, as when the new offering is part of one already outstanding, or when the syndicate, as sometimes happens, assumes a short position by confirming too many sales, and so must go into the market to purchase securities of the issue, often above the offering price.

The carrying account is credited with securities delivered to the participants for carrying purposes when the collateral loan is not made on joint syndicate account. It is debited with securities recalled from the participants, in each case at the offering price. Any securities not recalled are debited at the termination of the syndicate, representing those distributed *pro rata* among the participants.

In order to avoid disputes, syndicate records are usually kept with great care and are in many instances considered subject to access by syndicate members. Some time after the expiration of the syndicate, when all its obligations are definitely settled, checks are mailed to participants covering selling commissions and the *pro rata* share in the profits due them, and the operation is closed.

The market action of the issue after the closing out of the syndicate transaction will have a strong effect on the attitude of the clientele of the syndicate members, and the public in general, toward the participating houses. Therefore, the market movement of the issue after the termination of the syndicate or selling group, as well as during its life, is a matter of special importance. The question of security price movements, with special reference to the subject of maintaining a market in a specific issue, is treated in Chapter XX.

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Chapter XIX

SECURITY SELLING

Analysis of the Market

The success of the investment banker in distributing his issue depends, of course, upon his establishing an adequate buying clientele upon which he can regularly depend. It is evident, therefore, that the establishment of such a clientele, and the retention of it when established, are fundamentally important duties for the investment banker.

Differences of practice on this subject exist in different countries, and this difference may perhaps be best illustrated by the case of the United States and of Great Britain. In the latter country the effort is made to reach the customer through his general confidence in the issuing or selling house. In the United States, on the other hand, although of course the importance of general confidence cannot be over-emphasized, it is believed necessary to develop a much more highly specialized and personal mechanism for disposing of securities and a much more urgent method of forcing them into the hands of the customer. This distinction in point of view illustrates a fundamental aspect of investment banking—the type of solicitation or selling method which has been developed as most acceptable to, and most likely to succeed with, the investing public in any given case.

In analyzing this question, the investment banker recognizes almost at the outset that a great deal depends on the character and habits of the group in the community to which he expects to appeal in selling his securities. Thus, for example, a nation which is largely given to the placing of its surplus capital in savings banks, and which is not accustomed to the judging and holding of securities, is not likely to offer a particularly satisfactory field for the selling of bonds. In similar fashion, a group of bond buyers who have been habituated to the purchase of securities largely on the basis of safety, viewing them as an alternative to a savings account, is not likely to be strongly appealed to by offerings of more speculative issues whose chief attraction is not intrinsic security, but high yield or stock conversion privileges. Then again, the habits of the community with respect to yields, *i.e.*, the practices or customs which determine how much an individual expects on his investment, naturally influence the character of the securities which can be expected to sell well among buyers of this description.

Classes of Security Buyers

A determination as to the kind and character of the public to be approached and the methods to be used in reaching them is thus necessary as a phase of investment banking. The first step toward an analysis of the market by the investment banker, as a distributor of securities, is a recognition of various well-defined classes of purchasers, somewhat as follows:

1. Institutional or professional buyers—those who are themselves reasonably familiar with the character of the merchandise they are purchasing and are more or less able to judge it. In this class may be included:

   (a) Banks, investment trusts and other financial establishments which purchase for their own account and risk.

   (b) Trust companies and other fiduciaries which purchase on behalf of the owners of funds that have been intrusted to their care.

   (c) Special investment buyers, such as insurance companies, which have very clearly defined needs and buy securities with a view to meeting highly technical requirements.

2. Trade buyers who purchase with a view to retailing or disposing of the securities. Among these may be recognized the following groups:

   (a) Investment houses which deal with small investors and resell to them at a moderate commission securities which they themselves have purchased in the first instance.

(b) Individual purchasers of a semi-speculative type who are buying with a view to probable appreciation.

3. General investment buyers, including:

(a) Individuals who have a surplus of income over expenditure, or who are in possession of accumulated funds which they wish to use as a basis for income.

(b) Business establishments which find themselves from time to time with surplus funds in hand and, not wishing to leave these funds idle or producing only a nominal income as they might if deposited in a bank at interest, prefer to purchase securities with them.

Modes of Approach

It is evident that a different method of approach and a different kind of representation will be needed in these different cases, if the purchaser is to be induced to apply his funds in the direction desired by the investment banker. Broadly speaking, the investment banker may decide to operate on a wholesale[1] or a retail basis, that is, to endeavor to dispose of his issues in large blocks, or to take upon himself the task of reaching the general rank and file of the public. Should he determine to sell in large blocks, he will be inclined to address himself to institutional investors of the various classes already outlined and to interest them as far as practicable. In so doing he will necessarily rely to a great extent upon his general reputation and standing. Profit margins are smaller, and hence sales effort per unit sold must be limited. Advertising and direct mail contacts will constitute an important method of reaching the public to which he appeals, and here his effort will be to set forth as clearly and compactly as he can the character of the security which he is offering. This may be followed up with personal visits to, or communications with, known buyers of large quantities of securities, in the effort to induce such buyers to take as much as they are disposed of the issue immediately in hand. The knowledge of the buyer, as

[1] Not to be confused with security wholesaling in the technical sense, which means to sell to other dealers in securities.

well as his sensitiveness to advertising and correspondence appeals, reduces the relative importance of the salesman.

The other, and alternative, way of disposing of securities contemplates a retail method of distribution, and in this case far greater reliance rests on direct personal representation and solicitation. While it may be that the individual bond buyer is more or less directly reached and influenced by advertising of the right kind, it is also true in a great majority of cases that the advertising alone is not sufficient to induce him to buy. If he be inexperienced, he may refer the question of purchase of securities to his own banker for advice; or, in other cases, without any reference to experience, he may decide to buy what are called "seasoned bonds," that is, those that are already listed and proved on the exchanges of the country. In either case, his funds are not likely to go to the investment banker who is just bringing out a new issue without special effort on the latter's part.

It is evident that the choice of a method of security selling in any given case must be largely influenced by the number of prospects and the size of average purses which may be expected. Prior to the World War, a prevalent rough estimate placed the total number of habitual bond buyers in the United States at probably about 300,000. The number of stockholders was considerably greater, but consisted to a large extent of owners of closed corporations, who were not therefore investors in the proper sense. It also included undoubtedly a great number of persons who held shares only temporarily, having purchased their holdings on a speculative basis.

The number of *bona fide* security investors in this country before the war, therefore, was about 600,000. Several factors may be noted which had been tending to broaden the field of demand. It will be remembered that during the World War extraordinary efforts were made to distribute Liberty Bonds among as large a proportion of the population as possible, not only because of the government's need for the funds, but also because of the general system of war finance which had been determined on by the western countries, which dictated the value of as widely extended a distribution of public bonds as circumstances would permit. It is estimated that in the United States the total number of security holders thus developed eventually amounted to 15,000,000, including, of course, a great number of duplications and speculators.[1] Although many of these buyers were temporary and sporadic, a great many others retained the habit of putting their funds into securities of this type; and, although they may have disposed of their Liberty Bonds soon after the close of the war, they shifted over into other fields of investment and became buyers of other types of securities, instead of, as in former years, relying almost exclusively upon savings banks, farm and city mortgage investments and purely local securities of various kinds as outlets for their savings. The American capital market was thus made truly national in scope.

The same kind of education in bond buying and holding which was furnished during the war in the United States was also furnished in somewhat similar degree in various foreign countries. A net result of the war thus was to leave the various nations with a much more thorough and more accurate appreciation of the advantages of this type of investment than had been true in former years. After the war was over, a new era of expansion and of recapitalization set in in most countries, particularly in the United States, and large amounts of new capital were called for both on home and on foreign account; and this new capital had to be provided by appealing widely to the community for its savings. The business of issuing, dealing in, and distributing securities became immensely broadened and enlarged, and large groups in the community which had formerly been unfamiliar with bonds as investments began to take an interest in them.

As a result of this change it is estimated that at the present time the total number of habitual security buyers in the United States is probably not less than 7,000,000. It is probable that a majority of them now own stock, although exactly the reverse was the case a decade ago. Stock ownership has itself been popularized by customer ownership campaigns by

[1] Based on 1924 tax returns, Joseph S. McCoy, government actuary, estimated there were only 3,000,000 separate individuals owning corporate securities in that year. Tax returns, however, are believed by many statisticians to constitute an unreliable source of data on such subjects, for several reasons.

public utilities, generally rising quotations, and the growing stability of American industrial enterprises. In 1927, the Investment Research Committee of the Financial Advertisers Association estimated there were approximately 3,000,000 bond buyers in this country.

The Rôle of the Salesman

Widespread solicitation by bond salesmen who visit the customer and suggest to him the desirability of putting his funds into specified issues, such as is now in vogue, is the outgrowth of the desire of the investment banker to reach a large clientele by the retail method of disposing of bonds. It implies the organization of a considerable staff and the establishment of lists of prospective customers, assignment of names to each member of the staff and direct visits to the customer to induce him to part with his money in exchange for the bonds. Bond salesmen of this variety have usually been given some training, at least by the establishment which has employed them, and are expected to be able to furnish desired information with respect to general investment conditions, interest trends and the like, and to supply to the prospective buyer detailed data concerning the particular issue in which he may be interested.

Of late years, bond salesmen have usually taken upon themselves the additional task of giving general investment advice, keeping track of the holdings of bonds owned by each of their customers, suggesting appropriate times at which to dispose of old issues and buy new ones, and aiding in the preservation of a fair amount of diversification by the security buyer. Under such conditions, the bond salesman becomes a kind of investment counsellor to the customer or bond buyer. He takes the place which the broker assumes under the British method of bond distribution. His motive to sell, however, is stronger than that of his British contemporary, and his advice is very often unsolicited, whereas that of the British broker is furnished on request.

The sales force of the investment house is recruited to a large extent from the graduating classes of colleges. The young recruits are put through a short training course in the elements of bond investment and the general principles of selling. Taken as a whole, bond salesmen do not always adopt a strictly professional attitude toward their work by making an intensive study of security values and the needs of individual customers. They often stress such factors as possible rapid price appreciation and others which are not strictly of an investment character, in order to hasten sales. Intensive competition may compel the salesman in the future, in self-protection, to make himself far more expert than he is now in the intricacies of the securities business and the problem of security valuation, and in this task the technically trained man is certain to win eventually.

Men tend to concentrate in any business and profession in which the gains are large, regardless of their own personal fitness for the work. So the security business, which was of limited scope before the war, has attracted many thousands of men and some women from other walks of life to join in establishing large selling organizations which were created almost over night by the sudden growth of an investment class in this country. Between 1921 and 1928, the bond market enjoyed a remarkably sustained bull movement, in which the yields of representative bonds fell approximately 50 per cent. Under such conditions, of course, it was unusually easy to sell new security issues. On many occasions no selling effort at all was required, as investors, tempted by the possibility that the new bonds would rise in price even before they would have to pay for them, eagerly scrambled for the privilege of having their orders accepted. The later stabilization of bond prices brought on a period of more drastic competition, but the switch of investors' interest to more speculative stock issues again brought forward the appreciation factor. During the high money period which followed, salesmen had to turn to stock selling almost generally to get enough business to keep going, and the pure bond salesman faced a very difficult state of affairs.

Salesmen's Compensation

The security salesman relies for his compensation chiefly upon a commission for each bond sold, or for each share of stock if sold by the house as part of its regular offerings. In certain cases, the commission system is modified by the payment also of a fixed salary, generally of relatively small amount.

A study of practices in compensating salesmen in use among investment houses was completed by the Investment Bankers Association of America in 1928.[1] It reveals a wide variation among forty typical houses studied. They were fairly evenly divided on the basis of paying fixed salaries or merely permitting drawing accounts against future commissions. Houses which paid fixed salaries actually paid commissions in most cases only when earned commissions were in excess of the salary; but in several instances it was found that small commissions were paid on all sales in addition to the salary. Thus, one house paid its salesmen $1,500 to $5,000 a year, plus a credit of $1 per hundred face value of sales, paid monthly. This total payment was deducted from the aggregate commissions earned, determined on a basis of percentage of gross profit earned on each sale, and any balance was paid the salesman.

In computing commissions, investment houses generally give either a flat rate per bond or a percentage of the gross profit earned on the issue. Typical flat rate payments are $2 to $6 per thousand for general bonds, and $1.25 per thousand for municipal issues. Typical percentage commissions are from 10 to 40 per cent of gross profit. Many houses have a sliding scale of commissions, increasing the rate with the total volume of sales effected. Special credit may be given for bringing in new customers. In one instance, $10 is paid for each new customer on the third sale. Special bonuses based on competition among the salesmen or length of service are also common.

Finally, the question of establishing a uniform rate of commission has been agitated. Such a practice would doubtless tend to make the salesman more impartial as an advisor to his client, for he would not be interested then in pushing one or a few issues on which specially high rates were being paid. On the other hand, the present system of paying a percentage of gross profits, with extra allowances when business is poor, as followed by many houses, doubtless imparts considerable elas-

[1] "Interim Report of the Sub-Committee on Salesmen's Compensation," *Investment Bankers Association of America Bulletin,* 1928, vol. xvi, pp. 122-127.

ticity to the organization, permitting speeding up of sales effort when necessary by offering larger rewards.

Advertising

The direct selling effort is supplemented in many security houses by an advertising organization which is becoming increasingly complex. Often, a special department auxiliary to the sales department exists. Advertising is now used on a large scale, and in several different ways. First, new issues are given extensive publicity through the conventional "offering ads" which currently appear in practically every newspaper except the "picture tabloids." Then, many houses use different varieties of "follow-up ads," which appear after the original offering date and are aimed at furthering complete distribution of an issue of bonds with investors. Many bond houses run monthly offering lists, and a fourth type of advertising copy in common use is of a general institutional nature, where the investment house merely seeks to stress the advantages of investment in general and of its own services in particular, prominently displaying the name of the house at the same time. Institutional advertising also may take the form of "cards," or single column advertisements about six inches in length, briefly stating the name of the house and the character of business it transacts.

This advertising is not restricted to the newspapers. Conservative magazines now frequently have separate financial advertising departments, and car poster and billboard advertising are also not uncommon in the larger cities. Mail-order selling methods are also rapidly coming into favor. This further reflects the popularization of the investment market. Lists of prospects, gathered in various ways, are sent a stream of carefully designed letters and circulars, in order to broaden the list of clients of the house. A good description of advertising and mail-order methods from the practical standpoint is contained in the volume entitled *Advertising Investment Securities,* which was prepared by the Financial Advertisers Association. The organization of an advertising department in relation to the rest of the bond house is suggested in Fig. 13.

The rapid growth of investment advertising is significant. It reflects the fact that the rapid expansion of the capital market and the increasingly tense competition among investment houses is cutting profit margins, and therefore is making more economical distribution methods necessary. A successful mail-order campaign sharply reduces the selling cost per bond by increasing the sales volume. Paving the way for both direct sales and mail-order sales by periodical and poster advertising further increases the volume of sales and so reduces the burden of overhead expense per bond sold. It would appear that the tendency of the time is in the direction of steady reduction in

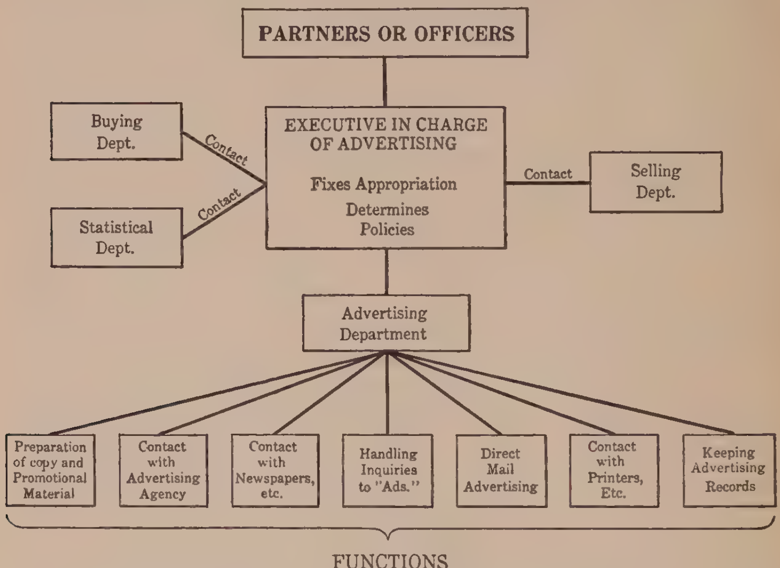

FIG. 13. ORGANIZATION OF AN IDEAL ADVERTISING DEPARTMENT IN AN INVESTMENT HOUSE

the expense of marketing securities through these methods, thus reducing the bond salesman's work and his rate of commission, while at the same time giving him the opportunity to dispose of a much larger volume of securities.

Advertising efforts are now supplemented by newspaper publicity, which plays a very important part in helping the sale of new security issues. The newspapers today depend for their financial news largely upon announcements issued by large corporations and financial houses through advertising agencies.

Several such agencies have a nation-wide organization. They receive their compensation primarily from the newspapers with which they place the advertising of their clients, while in addition they have a news department, made up usually of experienced journalists, which prepares "hand outs" for the press. Under this system, the financial press of America has practically abdicated in favor of the advertising agency in furnishing news about new security offerings to the public, and many houses have learned to make effective use of this situation.

Selling to Institutions

While it is doubtless true that direct selling of investments to individual buyers will continue for a good while to be practiced as the normal method of disposal of investment securities, and while it is doubtless true that, under the guidance of more or less well-informed advertising, the individual will become more and more discriminating in his purchases and may be expected to buy with greater intelligence, it is also true that a different attitude toward the purchase of securities is developing among investors, just as a different point of view with respect to their sale has already become more marked. This change may be described as the growth of an institutional method of securities purchasing.

One important reason for the increased need for expert investment buying is found in the fact that, with the rapid spread of corporate organization and with the broadening of the capital market to take in many new areas of competition, it has become necessary for the individual to supplement his own information by some systematic collection of data. So long as the securities offered to a buyer related to enterprises in his own immediate neighborhood, the prospective investor was able to pursue the dictates of so-called common sense in selecting his securities, and to guide himself more or less by what has been called those "slight but unmistakable evidences of veracity" which can be ascertained through personal contact, though usually not otherwise. The purchase of securities representing the credit of corporations or nations at a distance involves resort to scientific analysis of underlying values, for which the individual is often not qualified. Hence a necessary resort to some source of professional advice, or to that form of coöperative buying which we have termed "institutional."

The danger involved in such cases is, of course, that those who are furnishing advice for the guidance of the individual will be selfish or, in extreme cases, venal. Those who are operating investment trusts, for example, may want to take for themselves the benefits of good judgment shown in making purchases, and will allow to the investor only a very moderate or "normal" rate of return, while requesting him to carry the risk in the form of losses or depreciation of securities whenever their investment judgment turns out to have been bad. These risks and dangers are incidental to the process of development, and may accordingly be fairly liberally discounted. Eventually, it is fair to suppose, an increasingly large proportion of investment will assume the coöperative form, and this coöperative form will develop along institutional lines, as the various institutions become more responsible and as they develop a higher type of ethics. We may sum up this phase of the discussion, therefore, by concluding that coöperative or institutional investment bids fair to become the ultimate type of individual access to the market.

In making a study of the demand for securities, therefore, the creator or distributor of such securities naturally gives a substantial part of his attention to the wants of institutional buyers; and in analyzing their wants, he first of all directs attention to the statutory requirements which limit them in their operation. We have seen at an earlier point (Chapters IV and V) what these are in a general way. Obviously concerns which are limited to either a specified list of securities or certain groups of issues are customers only for those classes of securities. There is thus established at once for the investment house a buying nucleus which possesses a fairly measurable volume of demand, that volume from year to year being indicated by the annual growth in the total amount of resources placed in the hands of institutions of a specified kind. The annual increase, for example, in holdings of trust funds committed to the hands of trust companies affords one measure of the trust companies' demand for so-called "legals," that is to say, issues which under the terms of state laws are properly purchasable by fiduciaries. Switches in investment holdings are not common among such conservative institutions in normal times, except when caused by the maturity or calling for redemption of an issue held. In a similar way, gross amount of insurance written annually by life companies, and hence to be foreshadowed from year to year as representing the normal annual increase, may be taken as another measure of the market for new securities of the kinds already indicated as being legal for the investment of their funds.

Broadening of Legal Requirements

While it is thus possible to mark off certain elements of market demand for given classes of securities, it will probably always remain true that the larger part of the new issues must be sold to buyers who are not under positive legal control of this kind. In fact, recent legislation has seemed to show more and more clearly the existence of a trend away from narrow limitation of institutional buyers to prescribed classes of securities, and toward a plan which would base the work of such buyers upon the quality and character of such securities rather than upon any purely artificial or descriptive test. Stated more plainly, it is less common today to find the first mortgage bonds of specified railroads described as investments than it is to find the provision so broadened as to include any first mortgage railroad bonds which can present a definite income record on behalf of their issuers. Analysis of the buying field, therefore, soon passes out of that area in which a measurable demand can be noted for specified securities, and into a field in which the demand referred to may be regarded as applicable to securities of a certain grade.

Analysis of his market by the investment banker then consists of analysis of the extent of demand for securities of certain grades or classes; and the effort to classify bonds or other obligations develops. This is clearly an effort which can be successful only if some scheme of classification is first devised as a guide. As yet, no standardized grouping of the sort has made its way into general use. Several such classifications have, however, been attempted. Thus the Standard Statistics Corporation has devised a method of rating bonds which is described by it as follows:

> In the process of rating any issue of bonds, all factors of influence are carefully considered. There are, however, three fundamental factors that to a very great extent determine the real investment worth of any bond. These factors in the order of their importance are earning power, asset value and marketability.
>
> Standard bond ratings are offered primarily as guide posts in furtherance of the investigation of bond values and are therefore not intended to be accepted as final.

John Moody and the Moody Investors' Service have worked out the following symbols in their bond rating system:

Aaa: Meet the highest tests in asset value, earning power and stability.
Aa: Rank well into the high-grade field.
A: Entirely sound obligations of representative companies, but lacking the higher degree of protection obtainable in bonds of Aaa and Aa grades.
Baa: Generally make a good showing in the tests, but warrant more discrimination.
Ba: Always have some characteristics of uncertainty.
B: Always characterized by speculative features.
Caa: Usually have a decidedly poor statistical standing and fall short of all tests such as asset value, earning power and stability.
Ca: Show marked weakness of one kind or another.
C : Not to be classed as investments at all.

Such security ratings possess value, however, only in connection with bonds. In the field of stock issues, where present and prospective earnings per share constitute the important factor in value determination, they are virtually meaningless.

The investor, in making his choice of bonds, of course accepts these symbols of classifications as indicative simply of the judgment which has been formed concerning these securities by a statistical and analytical agency whose duty it is to obtain information concerning the changing conditions surrounding the corporations and governments which dispose of securities of the kinds referred to. Even allowing that no ulterior influences or considerations have acted upon the minds of the enterprises which are engaged in supplying data of this kind, they are, of course, subject to the same general restrictions and limitations that apply to any one judgment. Their opinions must accordingly be accepted with due reserve, and without any effort to take the decisions so announced as more than merely advisory or suggestive. The investor, in other words, if prudent, will undertake to "check up" carefully upon the opinions stated by the statistical services, by examining himself the statistics upon which they are based.

Adaptation to Needs of Investors

Much can be done in issuing new securities by way of adapting them to the needs of buyers. In order to accomplish this, attention must be given to the extent and character of the restrictions or qualifications that are imposed by existing law upon the investor, especially when he is of an institutional variety. If, for example, a given kind of underlying security is required by the terms of law or by custom as widely observed and followed, the result is to limit buyers of this class of investment security to those issues which correspond to their needs. Such issues can often be made to conform to the character of buying demand by clearing out of the way underlying issues of securities which conflict, for example, with the provision that a given type of investment shall be only in first mortgage bonds. Also, it is sometimes possible to arrange that specified requirements as to earnings are met by controlling the capitalization accordingly. In these ways, a new issue which would not otherwise be available for some classes of customers can be made to accord with their actual or imaginary needs, thereby enabling them to buy it.

The broadening of legal requirements, to which reference has been made in a preceding paragraph, is tending more or less to eliminate difficult conditions of this kind, and to get rid of restrictions that no longer have a real meaning because of the change in conditions that has developed since the original legislation was passed.

Education of the Investor

More important, perhaps, than the smoothing out and broadening of actual legal requirements, is the education of the investor to look at investment problems from a broader standpoint than he has been previously accustomed to. Many investors a few years ago had been in the habit of purchasing bonds only, in the belief that they afforded a safer or better protected kind of investment than they could otherwise get.

The individual's habit of applying his demand along specified lines of investment purchase may be largely the result of prejudice or ignorance. An explanation to him of the actual factors involved in investment, and a recognition on his part of the underlying fact that it is not the legal forms of investment but their essential characteristics that fit them for a place in an investment list, will often result in broadening his demand or changing the direction of it from narrowly specialized channels into much larger fields.

An example of what may be done in this direction is afforded by the rapid growth within recent years of the practice of buying common stocks instead of preferred issues or bonds. Recognition that the security, in any case, depends primarily upon the surplus and income of a given enterprise over operating expenses, and that the theoretical possession of a lien upon corporate property is not an especially valuable protection to an investor, naturally leads to a shifting of his interest from one type of securities to the other. This may be summed up by saying that the average investor frequently has no definite theory of investment, or that when he has, it is likely to be erroneous in whole or in part.

The ideas of investors and their attitude toward the whole investment problem, in fact, change slowly from period to period. Such changes in point of view often come suddenly and unexpectedly, and baffle bankers and investors. They result most frequently from changes in the business situation, which result in holding out hopes of large profits to be made through participation in the actual ownership of the business, thus rendering stocks more attractive than the bonds whose ownership places the individual in the position of creditor. Changes in taxation, business law, and ethics of business management may also exercise an influence in bringing about such results.

Preferences also vary according to the changing position of the individual himself. The "business man's investment" is one which represents a claim upon an industry which is changing its position from time to time, and which must be closely watched by observers who have access to a reasonably constant and reliable supply of data in order to protect themselves adequately. The investment to be made by the same person upon his retirement from business and withdrawal from active life will probably be quite different in its character. As the individual changes his relationship to property ownership and to other members of the community, the criteria which determine his selection of securities for investment likewise change.

The problem of selling securities involves the education of the investor in order that he may properly understand the point of view underlying securities issue and the real character of the protection that is offered to him by various types of obligations. Conversely, the attitude of the investor as a customer changes according to the investor's general knowledge of business and his varying appreciation of the elements of value underlying it. Changes in popular point of view on this whole subject account for broad transfers of demand from one group of securities to another—changes often attributed to alterations of rates or competitive conditions, when in reality they are the result of modification of the investor's attitude and scope of information, in part through the educational influence of the activities of the investment house, and especially of its salesmen.

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Chapter XX

MAINTAINING THE MARKET

Price Stability

The difference between investment and speculation has been sufficiently set forth in Chapter XI. It must be remembered, however, that what is ordinarily called speculation, as was there shown, shades imperceptibly into investment, and *vice versa.* It is not always possible, therefore, to draw a sharp line of demarcation. The point at which the investment banker directly comes in contact with speculation is found in the effects produced by the latter process upon the prices of the securities which he issues. Fundamentally the question is necessarily faced: How far does a newly issued security possess the quality of stability? Assuming that the investment houses sponsoring the issue have substantial clients, price stability should largely depend during the early stages of the new security's history upon the degree of skill and judgment that has been shown in adapting its issue price to the general level prevailing in the market at that time. But this is far from being a full statement of the case.

As a matter of fact, a security will maintain its price in the open market only if there are buyers on hand ready to take all offerings at the current price. If that does not prove to be the case, then offerings will be made at concessions by those who feel impelled to liquidate, until buying is attracted from one quarter or another. Furthermore, buyers must be on hand just when the offers are made. If they arrive on the scene too late, price concessions may already have been established.

Now when a new issue of securities is sold, it is likely that salesmen may have had to exert special effort to make each of the original sales. When certain of the buyers offer the securities they have purchased in the market, however, this specific sales effort is absent; and hence it is natural that the price tends to decline forthwith unless supporting orders are placed in the market by those specially interested in preventing a drop in the quotation—the investment banking houses sponsoring the issue.

Investment bankers ordinarily, therefore, undertake to maintain the issue price for some time, and especially, as seen in preceding chapters, during the period in which the issue is being sold to investors. The process of distributing a new issue of securities generally takes considerable time. It is not possible to forecast what disturbances will occur in the market during that period, and it is very desirable that while the process is going on there should be as narrow a fluctuation of value as practicable. Accordingly, the seller of securities is naturally concerned in an important way with the price of the issue after it has passed into the hands of the public. He wants to see it disposed of safely and permanently, and until that time he feels a special responsibility in connection with it. This statement holds true, no matter whether the new issue is or is not listed on the stock exchange or other organized institution for dealing in securities.

Of course, there are exceptions to this practice of price maintenance. If an unusual demand for the issue arises because of certain desirable features or favorable general market conditions, it may immediately sell at a premium, and no market maintenance problem arises. At other times, however, it may prove that the new issue of securities, after getting into the hands of holders, suddenly encounters some severe stock market disturbance. There is no reason why it should not "sell off" or "go to pieces" to the same extent that others of like strength do, and the offering syndicate may quickly withdraw its bids in the open market to avoid getting back the entire issue. Indeed, it is likely that since the new issue has not become firmly placed in the investment portfolios of institutions and individuals, it will suffer even more severely than other issues which may not be as good. Fluctuation in price immediately after issue under such circumstances does not necessarily indicate that the buyer has been imposed upon or that there has been an error of judgment on the part of the issuer, provided, of course, that the fluctuations are no more than those experienced by other securities of the same general description.

Duty of the Investment Banker

Thus the relationship of the investment banker to the securities market, and incidentally to what is called speculation, is seen to be necessary and, at times undoubtedly, close. In his effort to adapt the price of his issue to the valuations existing in the market at any time, he naturally guides himself by the figures prevailing there at the moment; and in his effort to provide a market and to regulate it after the issue has taken place, he necessarily assumes a position as a regulator or controller of market values to the extent that he is interested in securities through having issued them.

The question how far this duty on the part of an investment banker can be considered to exist is of great interest and has evoked wide difference of opinion, especially with regard to the relationship of the investment banker to the price of the issue after the primary distribution process has been completed and the offering syndicate dissolved. A house, for example, which is in the habit of entering into syndicate or other agreements looking to the maintenance of a given price for an issue of bonds during a period, say, of from three to six months, may not be willing or able to release itself from responsibility at the end of that period if it continues in the business of issue. Successive issues of securities bring successive assumptions of liability, and if many decline substantially in price it may not be able to retain its clientele. The investment house thus tends to remain continuously in the market as a stabilizing factor operating in those securities which it has itself put out. The fact that it has terminated its operations in one issue does not matter from the standpoint of the general analysis of the situation, if such termination has been followed by the assumption of new responsibilities in another connection.

On the whole, present practice recognizes that the investment banker has some vague responsibility for maintaining a market for an issue beyond the period of distribution, during which it is directly in his interest to do so. This responsibility is also considered greater where there is no exchange listing or other outside means of selling the security, should the investor wish to do so. In fact, in the case of several small investment trust flotations where marketability was lacking, the issuing company or banker has gone so far as to offer to repurchase the securities at a price fixed in relation to book value. However, the duty of the investment banker to aid in the maintenance of a market is not yet as clearly defined as is, for example, his obligation to help in the reorganization of a company whose securities he has sold.

Market Control

The subject of market control is one which has received wide attention from varying standpoints. It is, in the main, a topic which is of more interest to the speculator than the investor, being naturally more significant to that group in the community which depends upon fluctuations of value for profit than to those who rely upon dividends and interest as a source of income. Because, however, of the fact that many securities are promptly listed upon stock exchanges as soon as issued, and because of the growing desire for listing as a means of assuring marketability and availability for borrowing, the question of market control assumes a greater importance from the investor's standpoint than is the case on the more easily managed over-the-counter market. This is as much as to say that the investor is, by the present machinery of banking and trading, practically forced into a secondary position as a speculator, no matter whether he chooses to be so or not, since his security at once and automatically registers temporary changes affecting quoted values by reason of the fact that it has become the subject of day-to-day operations on an exchange.

The general question of market control, therefore, needs to be reviewed briefly in order that its bearings upon the investment situation may be understood. The price of a security in the market ultimately is dependent upon its underlying worth—for a bond the certainty of being able to convert it into money on its maturity date, and for stocks, available earning power. Certain price variations reflect changes in these underlying and fundamental conditions, and they are hardest to control. In addition, price changes also occur to a varying degree in response to technical market factors, such as the attitude of buyers, necessitous selling of one kind or another, or price manipulation. That these factors exert a control over security prices for varying periods of time is, of course, well known.

The attitude of investors is one of the most difficult of these technical factors to control. The investor who buys securities after careful investigation of their merits, or who is informed by persons he trusts that such securities are quite sound, is not likely to worry about them soon after their purchase. Having made his decision, he is, normally speaking, inclined to adhere to it, unless there should be new factors tending to alter his judgment. If, however, he sees that the security he has purchased tends to fall off in the market and is apparently not readily saleable, he is inclined to view the whole situation as having been unfavorably affected by some causes about which he is not informed. There is a disposition on his part to change his mind and sell the security he has purchased. On the other hand, if the price holds firm or increases, he is disposed to think of the security as having a stable value, and as being easily marketable at perhaps more than he paid for it. His disposition is thus to hold it.

By establishing price stability, investment bankers selling new issues render their own task easier. They prevent prospective buyers from believing that it is possible for them to buy the security in the open market for less than is being asked by the issuers. In floating any new issues of securities, therefore, the seller desires to have conditions so shaped that the price of the issue will remain stable, or perhaps will rise slightly, during the period in which the securities are being "absorbed" or are finding more or less permanent homes in the portfolios of investing institutions or in the strong boxes of investors.

Those who know this state of affairs therefore seek to control the market through establishing a favorable psychological attitude in investors. It is, doubtless, sometimes true that this sort of manipulation is limited to a very small group of issues; but at others, it may become much more widely diffused, and perhaps permeate the whole market for more speculative securities, so that the term "manipulated market" is not altogether a misnomer.

Methods of Control

A few fairly well standardized methods of control in such market operations are well recognized, and are somewhat classifiable. In order to peg a given security—that is, to keep it at a specified level—it is evidently necessary to stand ready to buy this security whenever it is offered at prices below that point. This kind of market support may be applied by placing supporting orders to buy everything offered at the pegged price. It then becomes impossible for the security to sell lower unless these supporting orders are exhausted. Thus, a certain limit of fluctuation is established, and the tendency of course is to have the price approximate the pegged valuation, unless outside orders carry it higher.

In the same way, if it is desired to prevent a security from going above a specified limit, selling orders must evidently be supplied in quantity whenever the price rises, in order to prevent an undesirable speculative demand leading to erratic price fluctuations. Short selling, in fact, is sometimes resorted to for this purpose.

When the issue has been fully distributed, the methods which may be followed for controlling the further price fluctuations of the issue vary. One system is to place in the market scale orders above and below the current market price. Thus, if the market price of a bond is 98, orders to buy in increasing quantity may be placed below this figure. They may provide for the purchase of 10 bonds at 97½, 20 bonds at 97, and 50 bonds at 96. Conversely, selling orders may be placed on a scale above this price. Hence, whenever a fortuitous supply or demand comes into the market for this issue, erratic fluctuations in price are avoided by these scale orders which are always on hand in the market; and frequently the investment house may make some profit from such orders by buying on declines and selling on advances. In fact, many large corporations, either directly or through affiliated investment houses or individuals, seek to stabilize the market price of their stock in this way. It is often said, for example, that this is the case with the stock of the American Telephone & Telegraph Company and that of the Pennsylvania Railroad.

Another method of maintaining the market frequently resorted to in the case of bond and some preferred stock issues, is the sinking fund device. This throws the burden of market maintenance from the shoulders of the investment banker to those of the original issuer of the security—government or corporation. The sinking fund creates a periodical demand for the issue in the open market, either through purchase or through redemption at stated prices. In either case, the visible supply is cut down and the technical position of the market strengthened.

Sinking funds are usually treated as if they were of chief interest to the investor, but the banker also has an interest in them. The establishment of a satisfactory sinking fund provision naturally has the effect of creating a demand for the issue, which has a corresponding effect in maintaining its value. If the sinking fund is carried on by direct reinvestment in the bonds to which it relates, the effect is the same as that of maintaining or pegging the market, within a limited range. For example, if the sinking fund calls for the purchase annually of 5 per cent of the total original issue of a series of bonds at a price not to exceed par, it evidently has the effect of creating a fixed annual demand for them up to a certain specified price, and, as the issue grows older, this annual demand becomes a larger and larger percentage of the total amount outstanding. In some cases, therefore, it may have a powerful stabilizing effect upon values, if its terms are lived up to rigidly. The investment banker, therefore, is wise to require the insertion of such a provision as a part of the purchase agreement.

The Problem of Listing

Admitting the need for market control, we may now turn to the discussion of the specific problems of the investment banker from the market standpoint.

Of these problems, the most fundamental is probably the question of listing. The investment banker may theoretically undertake to place his issues of securities in the hands of people who will "put them away and forget about them," but in practice he knows that this cannot be done. They are certain to form the basis of trading relations as owners find they must sell them. Even though he may for a short period arrange matters in such a way as to prevent any excessive speculative dealing in the issue, the investment banker cannot very long compel the buyers of the securities to adhere to any such plan. He must therefore decide, quite early in the discussion of a given issue, whether it is to be listed upon an organized exchange, such as the New York Stock Exchange, provided, of course, that the consent of that organization can be obtained, or whether it will be sufficient to leave the issue to be dealt in on the over-the-counter market; and if the latter, whether any special arrangements shall be made to assure an active demand there by interesting dealers in the issue.

First of all, if the security is to be listed on the New York Stock Exchange, such a decision involves the furnishing of some important items of information to the authorities of the exchange. Precisely what these are is indicated by the exchange in its regulations governing the admission of securities to its list; but in a general way they include fairly complete information about the financial condition of the company which must be kept up to date by at least one annual report. There may be reasons growing out of the position of the concern which render it undesirable to furnish the information thus required from the outset, or it may be felt that continuous compliance with the requirements of the exchange involves too great a sacrifice of convenience to warrant its being undertaken. What is more likely is that the issuers of the security are not desirous of having the security listed at all, because of their feeling that it may in that way become more subject to speculation and hence more difficult to control in price. Accordingly, the attitude of the investment banker toward the whole question of listing a new issue is likely to be two-sided, though it should be said that of late years the arguments in favor of listing have apparently had an increasing degree of weight, and the result has been that in more and more cases the question is decided favorably for the listing of a new security. However, a strong house may often prefer to make its own market for an issue on account of the greater possibility of profit through maintaining a wide spread between bid and asked prices.

A listing on the New York Curb or some out-of-town exchange may be tried. The placing of the security on the curb involves no such extensive or strict requirements as its admission to the New York Stock Exchange, especially if the issue is merely admitted to unlisted trading privileges.[1] However, the same objections to curb listing, so far as relate to speculative changes of value, exist as in the case of the stock exchange listing, except that the issue is less available for margin trading, and thus may attract fewer speculative buyers.

If the issue house decides against listing, it is likely to find itself under the necessity of making a market, or at all events of finding other dealers who will do this. Of course, this may mean that at times the concern which undertakes to make an over-the-counter market may find itself in the position of having temporarily to tie up a great deal of capital in the issue, as the result of buying in securities which are offered but for which no immediate buyers can be found. This may at times raise difficult problems for the sponsors of the issue.

The question of listing has received special attention from state authorities, and in general they favor it as an added protection to the individual investor. This is reflected by the fact that many states exempt from their blue-sky laws issues listed on recognized exchanges. The Attorney-General of New York State, in July, 1928, made the following statement on the subject:

> This office desires to again state its published opinion that an open public market where buyers and sellers of securities can be represented is so far preferable to a private market in its abilities to reflect values, to secure honesty of execution, and to abolish as far as possible unfair practices, as to be incomparable in its results. This office feels that any market which affords facilities for openly bringing buyer and seller together benefits the public, permitting as it does an open reflection of values.

Expanding the Market

Another phase of the function of providing a market for new issues is seen in the requirements of legislation relating to the investment of institutional funds. As things stand, various classes of bonds are eligible for purchase by such institutions as savings banks, insurance companies, trust companies and others. It is desirable that a newly issued security

[1] This is described in chap. iii, above, pp. 70-71.

should, as far as possible, comply with the requirements that have been laid down for the purchase of bonds by institutions which are likely to be interested in this particular class of issues.

Where a given security can be made to meet such requirements, the result may be to provide an automatic market for it. Failure to comply in all respects with such requirements may render it ineligible for purchase by various classes of institutions or special buyers, and may thus render it incapable of commanding as high a price as a bond of distinctly less worth which, nevertheless, conforms to the special needs of the institutions in question. Care in shaping the technical characteristics of the issue is thus in a great many respects a means of providing marketing facilities and stabilizing the value of given issues.

In this connection, something should undoubtedly be said with reference to the practice, which has increased in popularity in recent years, of attempting to make given issues attractive and thus extend the market and maintain their value by giving them a contingent interest in profits. It has, for example, been a frequent practice within the past five years to give to bondholders as a kind of bonus warrants entitling them to purchase stock in the enterprise at a fixed valuation. In other cases, bonds have been made convertible into stock on one basis or another. In any case, these features attract the interest of speculative buyers who would otherwise in all likelihood not be interested in the issue. Thus, the issue of securities of this description is in reality a marketing device, and this has been discussed in its broader aspects at the end of Chapter XIII above.

It may be noted about this plan that, in the case of a growing and expanding concern with steadily increasing profits, it largely reduces market control problems so long as the warrants are held by the bondholders. It may, however, result in the development of a special class of problems of the same sort applicable chiefly to those securities from which the warrants have been detached. The "ex-warrant" portion of the issue may be very difficult to control. On the whole, the method, although ingenious, is likely to prove a rather costly means of maintaining quotations and insuring marketability.

The whole question of marketing and of devices relating thereto tends to become more and more important as the holding of securities becomes a sporadic or occasional matter, instead of in effect the purchase of an income, as in former times it was intended to be, and for that matter still in many respects is. When the purchase and holding of securities are undertaken chiefly as a means of applying savings and insuring a vested income, problems of marketing and stabilization are comparatively simple. When, however, the purchase and holding of the securities is primarily a speculation or a matter in which the owner stands ready to treat his holdings from a strictly professional standpoint, changing or converting them in accordance with every expected distinct market change in values or yields, the problem of marketing or stabilization becomes much more complex. In the latter case, it is often an extremely difficult and technical problem, especially where the outstanding volume of a given issue is large, and where its appeal to the investor is based primarily upon its ability to pay a certain rate of interest dependent upon changing business conditions and the year-to-year prosperity of the enterprise which has assumed the liability.

Control of Stock Market Quotations

As investment banking houses have within recent years become increasingly interested in stock issues, the mechanism by which quotations are controlled on the New York Stock Exchange is of increasing interest to them. When an investment house puts out an issue of common stock which is then listed on the exchange, or a portion of an already listed issue, it must take full account of the mechanism by which prices fluctuate on the exchange. Otherwise, it may find the issue taken out of its control by speculative interests, or forced down sharply in price by short selling or other special market developments.

In general, the stocks listed on the exchange may be divided into two classes. A large number, generally the majority, are not being subjected to any special market action at any one time. These fluctuate in value more or less in proportion to the size of the "floating supply" of the issue, by which is understood the portion in the hands of brokers who hold it for margin speculators. The rest of the issue is supposed to be in the main in the strong boxes of investors and institutions. If the floating supply is large, fluctuations will tend to be wide and erratic. If it is small, the market usually is more stable.

When an issue is subject to special manipulation, on the other hand, it generally fluctuates more easily when the floating supply is small, for it is a widely observed fact that it is difficult to induce investors to part with long-pull holdings of securities. On the other hand, margin traders are easily induced to take profits after a rise. Therefore, most manipulative activities are based upon buying up the floating supply, then moving the price up without much resistance to a higher level, and then disposing of the issue to the public again. Experience has shown that the small traders and even the small investors are attracted to issues which are rising rapidly, and this facilitates the distribution process.

Where an issue has been largely distributed and the floating supply is small, the investment banking house can usually discourage much manipulation and keep quotations fairly stable by placing scale buying and selling orders, as was seen above. This device for stabilizing well-seasoned and well-regarded issues breaks down as a rule only at times of severe liquidation or in periods of wild speculative buying. Where the floating supply is larger, however, it becomes more difficult to prevent wide price movements in this way.

Although many investment houses refuse to become concerned with manipulative movements on the exchange, it is necessary for them to watch such movements in issues in which they are interested, and at times to discourage them by offering stock for sale to the manipulators. To see how this might be done, a brief account of a pool operation will be given.

Pool Operations

The most common type of manipulation, and the most effective, is the pool operation.

A speculative stock pool is a syndicate formed by a group of men who join for the purpose of acting together in raising or lowering the price of a security. Most pools aim at higher prices—some belong to the class of "bear pools" which profit by a decline. The pool discussed below, unless specifically indicated otherwise, is the "bull pool," which seeks higher prices.

In the typical pool operation, there are three important stages. They are:

1. *Accumulation.*—Here the pool, having been organized, seeks to acquire a block of the stock without disturbing the price. When skillfully conducted, this is accomplished without any public indication being given of what is going on. The particular stock is bought whenever it declines, especially when the general market is weak and liquidation occurs. When the stock tends to rise, the pool will leave the market alone, or, if necessary, throw a block of the already purchased stock on the market to lower the price.

2. *Advancing the Price* (*marking up*).—Having accumulated the stock, the pool is ready for the advance in price, as a result of which it will be established at a higher level and thus give it a paper profit. Under the best conditions, the pool will not have to buy much stock to put it up, relying on a few days of unusual activity to attract a public following. Such outside buying then automatically raises the price because the pool has already cleaned up the floating supply and thus made the quotation highly sensitive, as long as it does not itself interfere to prevent a rise by throwing a block of the stock on the market. In other cases, however, the pool may have to take large blocks of the stock sold by the public or others before the price can be advanced as desired.

3. *Distribution.*—In this third stage, the pool is ready to take its profit. If the public following is very large, it can usually dispose of the stock at the end of the rise, selling it in large blocks as the public buying becomes particularly intense. At other times, the pool will sell on the down-grade. This is done on the theory that the public will buy after a moderate decline, expecting the stock to return to its previous high price.

The above exposition of the typical pool action does not allow for particular developments which the pool foresees and which will greatly facilitate its activities. While many a pool engages merely in manipulation, the majority doubtless plan to discount some particular development which will tend to increase the value of the stock. Large earnings, a higher dividend, a stock dividend, a merger—these are a few of the contingencies which the pool may seek to take advantage of through the process of accumulation, marking up and distribution. It is an incident to the speculative market, making price movements more rapid and decisive.

The fact is that the so-called "public" is, from the speculative point of view, inert for the most part. It follows the "leader," "tips," and seeks suggestions from every source. The "insiders" and professional speculators, including banking houses and brokers, with their organization, superior means and better knowledge of the affairs of the individual company and of the technique of the securities market in general, show the way. In the long run, nothing attracts public buying so much as a steady rise in price of a security on active trading. And exchange listing, by attracting public attention, greatly facilitates such manipulation.

It must not be supposed that such manipulation is always successful, even under what appears the most favorable auspices. When the expected development does not occur, or, more frequently, when general conditions suddenly turn adverse and liquidation becomes general throughout the market, the pool may be forced to "unload." The pool is almost invariably a margin trader, borrowing on the stock which it buys. Frequently, it pryamids on thin margins, buying more after it raises the price of the stock already bought, which permits it to borrow on the first block the funds to pay for the second. Let an avalanche of selling hit the market, and the weak and badly conceived pools will see their stock thrown on the market by brokers and bankers who find the margin impaired. The annals of the Exchange are replete with stories of pools that failed in this way.

Manipulative activities of the kind described are not necessarily carried on by groups as indicated. A single brokerage or banking house may accomplish a similar purpose. Again, many variations may be found in the method of procedure. Frequently, owners of a large block of stock in which no active market exists will give a brokerage house or professional speculator an option to buy stock at a fixed or rising scale of prices. By raising the price of the stock above these figures, the brokerage house can then sell out the optioned stock at a profit, thus earning a return for the creation of the market.

The formation of pools is carried out in many different ways. In the case of large pools in well-known issues, an invitation may be broadcast, on a confidential basis of course, among Wall Street brokerage and investment houses. The latter may then aid in the distribution process by issuing circulars and other analytical data to the public, including their own clients.

One actual letter of invitation of this sort, with the names deleted, was as follows:

The undersigned agree and covenant to become parties to a trading account in shares of the ———————— issue.

It is understood that each party signing hereto assumes a 25% liability in the account and, as a condition of his becoming a member of this group, deposits immediately with ——————— $—— as initial margin.

It is understood by all parties concerned that this account is to be conducted strictly in accordance with the Stock Exchange usage and margins may be called from time to time in accordance with the Wall Street custom.

It is further understood that the maximum number of shares which this account can be long at any time is ———— and it is further understood that purchases and sales may be made from time to time in the discretion of the Manager or such person as he may designate to act for him in his absence from the city.

Mr. ———— is hereby designated as manager with full powers to act for the signers of this agreement and also to appoint any person, either interested or not interested in this account, to act as manager for this account during his temporary absence.

This account shall run for six months and may be extended for a further period not in excess of six months at the discretion of the manager.

Each party on signing this agreement becomes a participant to the extent of one-quarter of the entire account and shall be liable only for his proportion.

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Date ————.

From what has been said, it is clear that the problems of maintaining the market in stocks, and especially in listed issues, is far more complex than in the case of bonds and preferred stock issues not subject to public speculative trading on the exchange. The investment banking house, in justice to its clients, must adapt its market control policies to actual conditions in each case.

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Chapter XXI

INVESTMENT MANAGEMENT

Function of Management

In an earlier chapter[1] the organization of investing institutions was outlined, and the savings bank, trust company, investment trust and others were assigned their places in the general structure of American investment banking as developed within recent years. Only general reference was there made to the work of these institutions in their regular operation. It is now time to consider in some detail the practical application of that phase of investment banking which may be described as investment management—the care and supervision of the funds and investments of individuals or corporations by institutions that make it their business to invest for others.

Such institutions may, from this point of view, be divided into two broad groups. The first group receives funds from depositors or purchasers of their securities, and manages them in a common pool. Their earnings may be regarded as including two elements—a return on the capital employed, and a profit which represents the additional income earned through the special efforts of the management of the institution. Where such management is specifically designed to gain a maximum return, as in the case of the investment trust, this additional profit element may assume large proportions. The second group of investing institutions, typified by the trust company, specifically segregates the funds of individual investors, who thus receive the profits and sustain the losses on the capital they assign to the investing institution. The latter is remunerated by a fixed payment that normally has no relation to the results achieved in the investing process.

[1] Chap. iv, on Investing Institutions.

Management Institutions

While there are many institutions which might by some stretch of language be described as investment management institutions inasmuch as the funds intrusted to them are applied for the benefit of others to whom they really belong, we shall here consider only those which make the function of investment their primary task. This excludes the institutional investors, such as life insurance companies and large corporations, considered in Chapter V. These latter usually apply the same general investment policies, but adapted to their own particular needs. Among the investing institutions, the savings banks are too closely restricted by law to evolve comprehensive management policies. We shall therefore restrict our discussion in the main to three types of such institutions, the investment trust, investment counsel and trust company.

In all three of these types of investing institutions, the fiduciary relationship to the investor is conspicuous. The client turns over his wealth to the institution for the express purpose of having it managed by those who are more closely in touch with conditions than the client believes himself to be. The investment counsel may not actually take possession of the property in its own name, but may limit itself simply to giving advice; but in other cases, the counsel actually takes possession of the wealth on behalf of its clients. In either case, however, there is a relationship of trust. The investment trust takes the funds of its security holders, pools them and invests them. The trust company maintains a complete separation of each deposit of wealth placed in its hands for investment, and carries on the process as an individual matter.

Enough has already been said in the foregoing chapters of the technique of organization of the trust company and of the investment trust; the investment counsel represents a new type of institution whose organization is still unstandardized. We now turn to a survey of the actual methods by which such institutions deal with the sums of wealth intrusted to them by their clients. Such a discussion naturally includes two general fields or branches: (1) their management policy when the institution is left to deal with the funds intrusted to it practically without restriction, as its own best judgment may dictate, and (2) when it is guided by certain general requirements, whether of law or of individual establishment, which restrict its judgment in placing funds in the market.

Theory of Investment Management

Where any institution is intrusted by a client with a fund which is to be managed or invested for him, even where such management is left entirely to the discretion of the institution, the first question to be raised is, of course, one of theory or principle: by what standards or principles of conduct shall such an institution be controlled in its placement of the funds? Experience has dictated certain general principles or canons of policy which are generally recognized. The actual methods pursued by investment managers in dealing with the funds under their control may be taken as an illustration of the theory of investment, showing the extent to which they have been guided by such principles in their actions.

A survey of current management institutions which are able to direct their funds as they choose shows that there is no single or standard type of portfolio management policy, but that managers still follow theories of investment which differ from one another. Even where there is substantial agreement on basic theories, in practice they adopt points of view that are widely at variance with one another, because of the fact that investment methods necessarily differ widely according as the needs and requirements of individual beneficiaries differ among themselves. Nevertheless, there are a few general canons of investment management which are substantially similar in most of these institutions. These are the quality of securities, diversification and sales policy. The discussion of these principles will be carried on with special reference to the general management investment trust, as the least regulated type of investing institution.

Quality of Securities

Subject to such general limitations as a given investment institution may have set for itself, it desires, first of all, to have its purchases, whatever they are, "safe." This means in practice that depreciation in price will be unlikely, and that a large income or appreciation of principal is to be reasonably expected. Every purchase therefore must be tested from the standpoint of soundness, and this involves statistical analysis of such factors as assets, earnings, character of control, management, and the economic condition of the country in which the security is issued. These factors, and others of the same general description, have been touched on in the chapter on security analysis, and may be found fully discussed in any standard work on investment analysis.

Investment management first of all concerns itself with this kind of study, in order to make sure that within the general groups or types of securities which are to be bought, those which are actually selected for purchase shall come up fully to the standard of the group, and shall conform to such canons of desirability as the purchaser has laid down, however broadly or vaguely. In general, the desire of investment managers is to buy securities that have been "seasoned," although where a management believes itself to be in close touch with a group of originators or promoters in whom it has confidence, it may allow itself to take a position in issues which have not been seasoned but which have great possibilities of profit. This policy is of course more frequently to be noted in the case of investment trusts which are specifically organized for the purpose of carrying on investment in fields in which great profits are expected through appreciation of values, but in which any given security may, on account of the fact that it is new or the management untested, have an unfortunate experience. Illustrations of this practice of buying securities that are not seasoned, but represent distinctly new fields of investment, are furnished by chain store investment trusts, aviation trusts, and others of like kind. The existence of such exceptions does not prevent recognition of the general rule that investment management concerns, even where free to exercise their own judgment, are inclined to adhere to seasoned securities.

Some sample tests that are applied in judging of seasoned securities may be enumerated. A favorite one is that of requiring the existence of a continuous dividend or interest record over a period of years. Another is an earnings test, insisting upon the exclusion from purchase of securities which do not show regular earnings bearing a certain relationship to dividends or interest. Thus, for example, a general rule may be followed that no bonds are to be purchased unless the issuing concern has earned twice the interest for a given period of years.

Marketability is another test widely applied. It is not unusual to require that only those securities shall be bought that are definitely listed upon specified exchanges, the object in view being that of insuring at least a reasonable degree of saleability in case the managers should find it desirable to liquidate the commitment. Limitation of securities bought to an amount small enough to insure that the actual control of the concern shall rest elsewhere is intended to prevent the management institution from getting into the position of operating or being responsible for an undertaking in which investment is made.

Diversification

A second canon of conduct on the part of investment managers is that of diversification. By diversification is meant the distribution of investments in such a way as to avoid too great a concentration of risk. This diversification may take four different forms: that of division between types of securities, individual enterprises, types of industry and country. The chief illustration of diversification of the first type is found in the effort to apportion holdings between stocks and bonds. American investment trusts show a general tendency to favor stocks. In Great Britain, good practice seems to call for the holding of about 40 per cent of all investments in bonds, 20 per cent in preferred, and 40 per cent in common stock. One plan of recent development here has been that of carrying bonds and preferred stock sufficient to provide income for meeting the interest and preferred dividend charges of the trust, the balance then being put into stocks.

More elaborate still are the restrictions that are in effect under the second head, the diversification of securities held so as to avoid undue concentration in any one enterprise. A common requirement is that of prohibiting holdings in the securities of any one concern to an amount of more than 5 to 10 per cent of the sum handled by the investment trust. It is customary also to provide that not more than, say, 5 or 10 per cent of the aggregate amount of a security outstanding shall be purchased by the investment manager. Similar rules may govern the proportion of the investment fund which may be placed in any one industry.

Geographical diversification is afforded by prohibiting the investment of more than, say, one-third of the total fund in securities issued in any one foreign country. In most instances, also, there is a limit on the percentage of resources that may be placed outside domestic securities, for all foreign holdings may be adversely affected by wars and other special developments.

Policy as to Sales

No account of investment management would be adequate if confined entirely to the buying side of the portfolio. The question when to sell and when to "take profits" is, of course, the correlative of the question when to buy; and the two together constitute the problem of what is called turnover policy. Every investment trust of the general management type expects to improve its position at least to some extent through this process of turnover. In other words, it regards the income of the enterprise as consisting essentially of two factors, the return derived from dividend and interest, and that derived from profits on selling.

One of the principal American investment trusts asserts that it expects to make nearly one-half of its annual income out of turnover profits of this kind, which it estimates at anywhere from 14 to 16 per cent on the average capital employed by it. Obviously, no such profit can be made without some substantial skill in selling. In a general way, the investment manager desires to purchase securities that are moving downward or are at a low level, while he desires to sell when they are moving upward or are at peak point. He wishes, in other words, to foreshadow in some degree the cyclical movement of prices. By adapting their theory of business cycles to conditions in the various groups of shares, many investment managers believe it possible to get out of fluctuating securities, such as stocks, at favorable moments and shift their funds into securities that fluctuate little, such as bonds, and again to shift them back again when the more volatile securities have reached low point. In other cases, the cyclical theories are ignored, and instead securities are bought on the basis of advance knowledge of favorable developments in individual companies or industries. Other investment managers have claimed the ability to maintain a constant process of appreciation in investments through the shifting of funds from one market or country to another which is at a different stage of the business cycle or general economic development. There has as yet been no demonstration of ability to do any such thing over extended periods of time and through various types of markets. It is quite true, however, that through the maintenance of careful statistical and trading departments, and through constant comparison of values between different groups of securities, it is possible for an investment manager to shift by prompt action from one security or group of securities into others in which the possibilities of profit are greater.

Difference Between Discretionary and Dictated Funds

Up to this point we have been speaking of the management of funds which have been placed in the hands of an investment trust or investment counsel to use practically as they see fit, making it possible to apply an unrestricted technique of investment. We turn next to cases where this discretion is rigidly restricted, as, for example, in trusts growing out of the fact that deceased persons have left funds for management by others, or that living persons who are not capable or are not disposed to manage their own affairs desire to turn over the function of management. In such cases, the transfer of the management function may be accompanied by an agreement to leave the entire conduct of affairs to the manager, in which case the situation approximates that of the investment trust; or the transfer may take place subject to the laws of the community dealing with estates and fiduciary transactions. At other times, the specific provisions of a will or other document, in which definite conditions are laid down for the management of the funds, govern the process. Work of this kind is more and more generally, especially in the United States, placed in the hands of trust companies, and is sometimes referred to as fiduciary banking. It is accompanied by the performance of many other functions which have only an indirect relationship to investments, such as corporate trusts.

In the exercise of its function as investment manager, the trust company under all circumstances keeps the general canons of investment before it as a guide. In addition, it must conform to two other series of regulations. These are:

(1) The trust deed or instrument that accompanies the placement of funds with a trust company, and which is designed to indicate to the concern the desire of the person creating the trust.

(2) The fiduciary law of the jurisdiction in which the trust is established, and which, in the absence of any specific instructions on the part of the original owner of the property, dictates the manner in which it shall be administered in the interest of its ultimate possessors. Such law may control or direct the use and disposition of the property in exceptional instances in a manner contrary to the expressions conveyed in the trust instrument itself.

A survey was made in 1925 of the investment policy of more than 200 trust companies and trust departments of national banks. This study revealed that trust companies taken together followed about the same policies in investing "legal" trust funds as those which were subject to their discretion, except for a moderately larger percentage of the latter invested in corporate securities. The distribution for discretionary funds was approximately as follows:[1]

[1] Smith, James R., *Trust Companies in the United States*, pp. 427ff.

Investment	Percentage of Funds Invested
Real estate, mortgages and mortgage bonds	56.7
U. S. bonds	12.8
Municipals	9.1
Railroad bonds	4.6
Railroad stock	.7
Public utility securities	5.4
Industrial bonds	4.5
Industrial stock	2.6
Bank and insurance stocks	1.4
Foreign bonds	.5
Miscellaneous	1.7
Total	100.0

Lately there has been a marked tendency to invest a substantial portion of discretionary estates in seasoned stocks, largely in response to the desire of clients of the trust companies who reflect the growing public favor seasoned equities now meet.

The trust company, in its work as individual trustee, acts usually as executor, administrator, guardian and trustee. In all individual trusts, the first and essential step on the part of the trustee is to obtain at the outset a copy of the trust instrument and to familiarize himself with its terms, thereafter guiding his conduct entirely by the orders therein given in so far as they are not in conflict with existing law or legal and judicial practice. If the trust instrument has afforded definite instructions which leave no element of judgment open to the trustee as, for example, if the fund placed in the hands of the trustee is in cash and is accompanied by instructions to purchase a specified kind of securities, keep the fund invested in these same securities and pay the income to designated persons, the matter is relatively simple. But in most cases an element of judgment emerges; and even where the instructions appear to be perfectly plain and unmistakable, it not infrequently happens that changing conditions, the withdrawal or retirement of given securities, the failure of others, and so forth, throw into the hands of the trustee a degree of discretion not expected at the outset. This makes it important to know in general terms what the position of the courts on the subject has been and exactly where the investment responsibility of the trustee begins and ends. This is outlined in full in the appendix to the chapter.

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Appendix

The following survey of the question of trustee responsibility has been prepared by a councillor of one of the principal trust companies of New York City, who has sketched therein the outlines of the present legal and judicial situation as applicable to it:

Legal Responsibility of Trustee for Investment of Trust Funds

SUMMARY

1. *General Factors in Choice of Investments:*
   - a. The trust investment:
     - Wording necessary to vest discretion
     - Effect of consent of adult beneficiary—not a minor or an incompetent
   - b. Statutes and court decisions
   - c. Situation and needs of the beneficiaries
   - d. Economic conditions

2. *General Duties of Trustee Regarding Investments:*
   - a. To invest within a reasonable time
   - b. To invest within court's jurisdiction
   - c. To make no individual profit from trust funds
     - Sale of securities to trusts
     - Mortgage participations
   - d. To keep trust funds separate
     - Temporary deposits in banking department
     - Deposit designated as Trust Fund

3. *Legal Principles Governing Nature of Investment:*
   - a. "Prudent man" theory
   - b. Speculation excluded, but investment permitted

c. Relative importance of safety of principal versus amount of income
d. Reasonable diversification required
e. Trustee not surcharged for losses on perfectly proper securities

4. *Continuation of Investments:*
a. Those made by creator of trust
b. Those received from predecessor trustee
c. Business of decedent

5. *Concrete Restrictions on New Investments:*
a. Margin stock speculation barred
b. Active conduct of business barred
c. Company must
NOT BE NEW
HAVE DIVIDEND RECORD
HAVE AMPLE PROPERTY
d. Security must be SEASONED and BE WELL REGARDED AS AN INVESTMENT
e. Trustee must consider condition of the industry
f. Industrial common stocks admitted

DETAILED ANALYSES

1. *General Factors in Choice of Investments:*

Each trust's investments present a separate problem. The choice of its investments depends upon four factors:
a. The Trust Instrument
b. Statutes and Court decisions
c. Situation and need of beneficiaries
d. Economic conditions

The definite instructions, if any, contained in the trust instrument and the intention of the trustor as indicated in a reading of the entire document are the most important.

a. *The Trust Instrument:*
The Trust Instrument may appoint the Company sole trustee or co-trustee. It may place varying degrees of responsibility upon the Company by making the investments
1. controlled by the donor or others, so that the company acts merely as agent
2. subject to the approval of the donor
3. controlled solely by the Company

From another point of view, trusts fall into two classes:
1. Those in which existing investments are turned over to the Company as trustee and the question of their retention or change merely arises
2. Those in which a sum of money is turned over to the Company as Trustee, which it is to invest

Regardless of the party upon whom responsibility for investments is placed, the trust instrument may either:

1. Permit new investment only in legal securities
2. Permit wide discretion in investing funds

If the instrument is silent as to character of investments permitted, the Company, as trustee in New York State, may follow only the dictates of the State Law.

If it invests outside the "legal list," it does so at its own risk and must bear loss resulting therefrom. It makes no difference whether or not the Company invested with ordinary care and prudence, but it is liable just as if it had disregarded the instructions contained in the instrument and invested in securities other than those specified therein. Many trusts, however, vest discretion in the Company as Trustee to invest as it sees fit in "non-legals" outside the authorized list, but its discretion is not arbitrary or uncontrolled.

The instructions vesting general discretion in the Company as Trustee must be clear and specific. The wording is now well understood.

In a legal trust, however, where all the beneficiaries are of full age and under no legal disabilities, their consent sanctions the investment and waives their right to hold the Company as Trustee, responsible for loss. It must appear that the beneficiary knew all the facts, was apprised of his legal rights and under no disability to assert them. He must have acted freely, deliberately and advisedly, with the intention of confirming a transaction which he knew, or with reasonable diligence ought to have known, to be impeachable. The Company, as trustee, sustains the burden of proof.

b. *Statutes and court decisions:*

Regardless of the discretion conferred, the conduct of the Company, as trustee, is subject to review by the Court. Reckless and wilful abuse is not permitted, but good faith is required, even though the discretion granted be absolute.

Most of the investment principles represent older ideas rather than current views, and most of the instruments creating trusts were drawn years ago. The Trustee is held to strict accountability and emphasis is placed upon conservatism.

Trust Companies as trustees are subject to the same rules of law as are individual trustees, but it is possible that they may be the more subject to a standard of reasonable conduct by the courts in considering the facts in a particular case.

c. *Situation and needs of beneficiaries:*

The Company as trustee must consider the interests of both life beneficiary and remainderman. It must carry out the purpose of the trust to provide for both and adapt its investments to their requirements.

d. *Economic conditions:*

Finally, the Company must consider the general economic situation when investing trust funds. The economic outlook for an industry determines the desirability of investing in its securities. The general economic situation makes investment in bonds preferable at certain times to investment in stocks, or investment in long-term obligations preferable to investment in short-term.

2. *General Duties of Trustee Regarding Investments:*

The general duties with respect to investments of the Company as trustee, are four in number:

a. To invest within a reasonable time
b. To invest within the court's jurisdiction
c. To make no individual profit from the trust funds
d. To keep the trust funds separate from its own

a. *To invest within a reasonable time:*

In order to make the trust estate produce an income the Company as trustee is required to invest the trust funds within a reasonable time. This rule applies also to any interest or increase which comes to the estate and which is not distributed. A "reasonable" time has been variously defined by the courts; but in New York State, negligently permitting the funds to remain idle renders the Company as trustee liable for interest on the funds at the legal rate.

b. *To invest within the court's jurisdiction:*

The Company, as trustee, must not make investments that will remove trust property beyond the jurisdiction of the court supervising the trust. This requirement dates back and applies to the time when real estate was a leading form of property bequeathed, and is not applicable to stocks, bonds and similar securities.

c. *To make no individual profit from the trust funds:*

The Company, as trustee, is not permitted to purchase from itself or at its own sale, except at a mortgage foreclosure sale, to protect the beneficiaries. The law does not stop to inquire into the fairness of the sale or the adequacy of the price, but stamps its disapproval upon the transaction which creates a conflict between the self-interest and the integrity of the trustee. The trustee is not permitted to obtain any profit, direct or indirect, from its dealings with the trust property, other than its lawful compensation. If it does, it is not only liable for the entire fund and interest thereon, but also for such profit as it may have made, the beneficiary having the option to elect whether to take the fund with interest or with the profit.

This matter is of importance to institutions which have a bond department. Two questions arise in such cases: first, should the bond department sell securities to the trust department; and if so, second, upon what basis? California institutions, *e.g.*, answer the question in two ways. Some execute all orders for the purchase of securities through an outside dealer and buy securities only from outside sources in the open market—never from the institution itself. Others, however, feel that they have special facilities and desire to give their trusts the benefit of their expert opportunities, knowledge and judgment. Hence when they are syndicate members, they sell securities to their trusts at the wholesale price, feeling that the good will resulting will indirectly prove ample compensation.

In New York State no direct legal decisions exist on the matter. An exception is made of participating mortgages in which the Company is specifically authorized to invest trust funds. The Company holds the mortgage and issues participating certificates to the various beneficiaries. The small estate benefits by becoming productive at once. The practice was recognized as proper by the Court of Appeals in 1916, confirmed in 1918 by an amendment to Sec. III of the Decedent's Estate Law & Sec. 21 of the Personal Property Law, and further approved by an opinion of the Attorney-General of the State of New York in 1924.

d. *To keep the trust funds separate:*

Since the trust company must have no personal interest in its dealings with the trust property, it must keep the trust funds entirely separate and not mingle them either with its own funds or with those of other trusts. Sec. 231 of the Surrogates Court Act specifically required this in the case of testamentary trusts, although the statutes are silent as to voluntary trusts.

The trust company, however, may temporarily deposit in its banking department trust funds awaiting investment by the trust department. Sec. 188 Sub. 11 of the New York Banking Law permits such deposit in its name as trustee. On sums of not less than $100 the Company shall allow interest at not less than 2% per annum until expended or distributed. If unexpended or undistributed for one year, it is added to the principal of the trust fund, and is itself subject to interest.

3. *Legal Principles Governing Nature of Investment:*

The Courts in certain leading cases have laid down a few fundamental principles to be observed in investing trust funds, in the absence of words in the will conferring greater discretion. Massachusetts does not limit trustees by statutory enactment to certain classes of securities, and in 1830 the Court in Harvard College *vs.* Amory laid down the following guide for the trustee:

"to observe how men of prudence, discretion and diligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of the funds, considering the probable income as well as the probable safety of the capital to be invested."

The New York Courts have adopted the same tests, in particular for those trusts which vest discretion in the trustee, the leading case being Matter of Hall, handed down in 1900.

The decision contains several significant features:

a. It lays down a "prudent man" theory.
b. It distinguishes between speculation and investment.
c. It emphasizes amount of income as well as safety of principal.

Good faith is of course, fundamental.

a. *"Prudent man" theory:*

The general rule was early stated (1869) in the following words: "The trustee is bound to employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters employ in their own like affairs."

The degree of care to which the trustee is held is not his opinion of the security nor that of some interested party, but what a normal or prudent man would think of it as applied to his own personal transactions.

b. *Speculation excluded, but investment permitted:*

In view of the "prudent man" theory, the courts exclude speculation as distinct from investment.

The tests of a speculative transaction have been laid down in various cases. They are included in the following pronouncements:

1. Investment for an uncertain and doubtful rise in the market.
2. Its purpose is to increase the estate or realize a profit from the transaction, while the purpose of an investment is to secure an income.
3. It will generally be conceded that a mere business chance or prospect, however promising, is not a proper place for trust funds. While, of course, all investments, however carefully made, are more or less liable to depreciate and become worthless, experience has shown that certain classes of investments are peculiarly liable to such depreciation and loss. These, of course, should be avoided by every prudent man who is investing his own money with a view to permanency and security rather than chance of profit. A trustee should, therefore, avoid them, even though he sincerely believes a particular investment of that class to be safe as well as profitable.

The exclusion of speculation raises the question—may the trustee purchase common stocks with trust funds? (Sec. 5f.)

c. *Relative importance of safety of principal versus amount of income:*

In view of these tests of speculation, it is not surprising to find that Courts of Law generally hold that it is the primary duty of a trustee to maintain the principal of the trust intact.
Hence a decrease in the income of the trust can be more easily explained than a decrease in the principal, but a decrease in income would incur the ill-will of the beneficiary.

d. *Reasonable diversification required:*

In addition to these requirements, the courts oppose over-heavy investment in one security, regardless of the merit of the security. The mere fact that a substantial investment is made originally does not absolve the trustee from liability for a substantial further investment in the same security.

e. *Trustee not surcharged for losses on perfectly proper securities:*

In a legal trust the trustee is surcharged for losses if it selects investments from outside the legal list. In a discretionary trust, it is surcharged only in case it fails to heed the requirements laid down in 3 a–d just given. Where a trustee buys only perfectly proper securities, hence exercises sound discretion, he is not surcharged in the event that some depreciate. In a case where some common stocks were included among the securities purchased, the court stated that "he should receive the benefit of the care and prudence with which he has administered the estate and not be mulcted in damages when the whole estate has been administered so as to yield a profit, because certain of the investments may not have turned out as had been anticipated." No case has yet been decided in which an aggregate loss ensued in place of an aggregate gain.

4. *Continuation of Investments:*

Some trusts, as already stated, involve the question whether or not investments received from others should be continued. It is necessary to distinguish three cases, according to the origin and nature of the investment:

a. Those made by the creator of the trust
b. Those received from a predecessor trustee
c. Those involving continuation of the decedent's business.

Two questions arise:

1. How far may the trustee go in disposing of the securities he holds?
2. What are the circumstances under which he comes under a duty to dispose of the securities, as a preliminary to reinvestment?

a. *Those made by creator of trust:*

The first duty of the trustee is to call in the estate preparatory to investment. The trust instrument, however, may specifically authorize a continuance of the investments made by the creator of the trust. Otherwise, in New York State it has been decided that the investments the creator made afford no criterion for the trustee and that it is the latter's duty to call in the estate and invest it in authorized securities. As a general rule, this must be done within one year, but a trustee is permitted to use his discretion and may not be liable if he retains the investments for a longer period, awaiting a favorable market. In the discretionary as distinct from the legal trust, the trustee may continue investments made by the creator, which the trustee in the exercise of good faith and ordinary care considers safe. The fact that the creator made the investments may be considered a recommendation or suggestion that they are worthy of retention. One decision states:

> "There is a great difference between an investment made by the trustees of moneys forming a part of the estate and the retention of securities purchased by the testator and held by him at the time of his decease. In one case the investment, whether wise or unwise, is the independent uncontrollable act of the owner, and in the other it is the act of the trustees whose discretion is limited and whose duties are prescribed and each is to be subjected, therefore, to wholly different rules of law, if indeed, the act of the owner is subject to any rules whatever."

If the trust instrument makes a specific gift of certain stocks or securities, the trustee is not liable in retaining them.

b. *Those received from predecessor trustee:*

A trustee may have unauthorized investments turned over to him by a predecessor trustee. He should ascertain which have been purchased by the predecessor, as distinct from the creator of the trust, and dispose of them. He is allowed a reasonable time in which to investigate the investments he takes over and make such changes as may be necessary. But where a court forces a trustee to take over from his predecessor securities of speculative value and possibly unsaleable, he is required merely to act in good faith in dealing with them and is not liable for loss if he uses his best judgment.

c. *Business of decedent:*

The general rule is that in the absence of express authority either in the document creating the trust or by order of the court, an executor, administrator or trustee may not continue a trade or business carried on by the decedent at the time of his death. The reason is that trades and businesses are hazardous and conduct of them is not within the scope of administrative functions. Even when the power to continue a business is conferred by the trust instrument, it is strictly construed.

In certain cases, an executor, administrator or trustee will be permitted to carry out contracts made by the decedent, or to carry on a business or to complete the manufacture of unfinished articles, or to incur liabilities when such a course is for the best interests of the estate, but even in the exceptional case the trustee should protect himself by an order of the court.

The trustee should not continue the business as a sole proprietorship or partnership, but as a corporation, so as to limit its own liability. The instrument should specially relieve the trustee from the consequences of poor business judgment. It is asked in such cases to do more than the ordinary trustee and to undertake more work.

5. *Concrete Restrictions in New Investments:*

The general principles stated in section 3 have been applied in a number of specific instances. As a result, the following concrete restrictions on new investments have been laid down:

a. Margin stock speculation is barred.
b. Active conduct of business is barred.
c. The company whose securities are purchased must
   a. Not be new.
   b. Have a dividend record.
   c. Have ample property.
d. The security must be seasoned and be well regarded as an investment.
e. The trustee must consider conditions in the industry.
f. Industrial common stocks may be purchased for a discretionary trust.
g. Express or implied power to invest is necessary.

These restrictions are especially important for those securities not on the legal list. They relate primarily to the individual security, and do not penalize a trustee who buys at the top price in the market, provided that he buys a standard security.

a. *Margin stock speculation barred:*

The courts have opposed margin stock speculation, even where begun by the testator and merely continued by the trustee.

b. *Active conduct of business barred:*

The courts frown upon active participation in the affairs of corporations, even where the trustee claims that he is carrying out the developmental plans of the testator by engaging in such new ventures. Only business undertaken by the decedent can be carried on under the conditions mentioned in 4 c.

c. *Company must:*
not be new;
have dividend record;
have ample property.

These requirements obviously hark back to the idea of a prudent man investing his funds with care, for they represent commonly accepted tests for an investment security. In case of a consolidation, the company must not represent such expansion as to be substantially a new company.

d. *The security must be seasoned and be well regarded as an investment:*

These requirements are allied to those contained in c. A company which is not new, so that it has been conducted successfully over a long period of time, has a dividend record and has built an ample property, soon enters the class of seasoned investments. Thus established, its securities become well regarded as investment issues and acquire the confidence of investors.

e. *The trustee must consider conditions in the industry:*

Investment involves consideration of the company, the issue and the underlying conditions in the industry in question. Most decisions refer to the condition of the company, but a few consider the immediate and prospective situation in the industry at the time of investment. This requirement adds greatly to the trustee's responsibility.

In 1924 a trustee inexperienced in investment matters, who sought the advice of a well-known financial institution, was surcharged with the amount of bonds of a steamship company which defaulted soon after organization, on the ground among others, that he should have realized that in 1919 the steamship business was grossly inflated.

6. *Industrial Common Stocks may be Purchased for a Discretionary Trust:*

Much controversy exists on the merits of common stocks as investments for trust funds. A trustee is permitted, under various decisions, to purchase common stocks which meet the tests laid down in the preceding sections.

Chapter XXII

REGULATION OF SECURITY SELLING

History of Regulation

While banking regulation has been known in this country from the time of the establishment of the first commercial banks, the security business has escaped specific regulation until recent years. Investment banking was fully developed only long after commercial banking was established, and it affected directly, until recently, a much smaller segment of the population. Hence, the demand for government control was not as great. The banks, especially in their note issue function, came into contact with virtually all elements in the community.

Although laws to regulate the issuance of securities were known in Germany and France before 1900, and in England such legislation was passed at the opening of the present century, no such general laws appeared on the statute books of an American state until 1911. Only in the case of railroad and public utility securities did the states pass laws giving jurisdiction over their issuance to duly constituted commissions with varying degrees of power. A number of legal enactments were made in several states governing security trading, as distinct from new issues. Some of these, such as the laws of 1812 forbidding short selling in New York State, fell into disuse or were repealed, while others continue to regulate the security brokerage business down to the present day.[1]

The first law regulating the sale of investment securities was passed in Kansas in 1911. It bore the name of blue-sky law, a term which has since been applied generally to this type of legislation. The name was first applied to "high-pressure" promoters who at that time infested the state and sold fraudulent securities to farmers in huge volume. These promoters

[1] A full discussion of exchange and brokerage law may be found in Goldman, S. P., *Stock Exchange Law.*

had come to be called "blue-sky merchants" because some of them were said to be bold enough to offer to the farmers, unversed in investment matters, title in fee simple to the blue sky itself.

The Kansas law, passed without regard to European experience and the nature of the investment banking business, was too extreme in its original form. It made the state the guardian of the people's investments. A Charter Board was created which was to allow the sale within the state only of securities which held out promise of dividend payments, and which were issued by businesses which were "honestly, fairly and justly managed." The law expected too much of the Charter Board, and as a matter of fact that body soon reduced its investigations to a perfunctory basis. Nevertheless, the blue-sky merchants were frightened and their depredations were sharply reduced. Later, Kansas modified her law to involve less jurisdiction over the speculative quality of securities by the Charter Board, in response to an adverse decision of the Supreme Court.

The Kansas statute was almost immediately copied by the province of Manitoba, Canada. Other states successively passed laws along similar lines. For several years, the fate of the blue-sky laws hung in the balance because of litigation over their validity and scope. They were attacked chiefly on grounds of unconstitutionality, and their opponents won a number of victories in the state and lower federal courts. However, the Supreme Court came to the rescue, and in 1917 a series of cases declared the blue-sky laws of Ohio, Michigan and South Dakota constitutional as an exercise of the police power of the state.[1] On the other hand, the states were prevented by the highest court from exercising jurisdiction over sales of securities within their borders from without the state, through the use of the mails or other forms of communication. The case of Hall *vs.* Geiger Jones Company (242 U. S. 539) declared such sales made from outside the borders of a state to be interstate commerce, and hence subject to the jurisdiction of the federal government. The court held in this decision

[1] Merrick *vs.* Halsey, 242 U. S. 568, was a leading case bringing out this doctrine.

that the states have the power to license and regulate all persons who dispose of securities within the state, even when they originate from the outside, as "a police regulation strictly." Where there is no person so doing reachable, however, the state is powerless. At the present time, it is generally declared, the bulk of security frauds take place through the use of the mails, the state blue-sky laws having sharply reduced intrastate fraudulent selling of this kind.

A total of 43 states now have blue-sky laws properly so called. The jurisdiction over security issues in these states is put into the hands of security commissioners, who, in the interest of effective coöperation to prevent security frauds, have formed a National Association of Securities Commissioners. New York, New Jersey and Maryland have not adopted such legislation, strictly speaking, but have what is known as an anti-fraud type of law. In fact, only Nevada and Delaware, among the states, have no security legislation at all. Finally, the federal government has taken action to prevent security frauds through the use of the mails. In their effort to reach the fraudulent security vendor, these regulations affect the business of the legitimate investment banker, and he must make sure that he meets such legal requirements before selling new issues in the several states.

Blue-sky Laws

The basic theory behind the blue-sky laws is that a corporation, being a creature of the state, has an implied approval by the state in the issue of its securities. If these securities are fraudulent, the state, which has created the corporation, has authorized their issue. Hence, because of this implied approval, supervision of these security issues becomes desirable.[1]

Blue-sky laws regulate security issues chiefly through two important channels. In the first place, dealers and brokers offering these securities are required in most cases to get a license from the securities commissioners or cognate officer, or at least to register with him. In this way, unreliable or fraudulent individuals and firms can be kept out of the secu-

[1] This theory is not the one which the Supreme Court adopted in upholding the legality of blue-sky laws, however. It adopted the police power theory, as has already been seen.

rities business in the state. Secondly, specific issues of securities are under certain circumstances required to be licensed or "blue-skyed" by the securities commissioner.

The licensing of both the security issue and the dealer or broker offering it is required in most states; but there are several, such as Texas, which rely upon the registration of securities or the issuing corporations themselves, rather than upon the dealers putting them out. In states like Illinois and many others, where the dealer or agent offering the security is merely registered with the Secretary of State under a relatively small bond, the major reliance of the law is upon the requirements concerning the security issue itself, which must be fulfilled before it may be offered for sale within the state. Registration mainly serves the purpose of facilitating the service of legal process on dealers who violate the law. The Illinois law, in fact, specifically states that "the Secretary of State shall not issue any certificate or written evidence to any person registered as an owner, dealer, broker, solicitor or agent." In this way, the state avoids giving an implied assurance of the reliability of dealers, such as is given in states where formal licensing is required.

Regulation of Dealers

In their regulations licensing dealers, the blue-sky laws have two distinct aims, as has been seen. In the first place, many of the laws seek to elicit enough information before granting a license to assure that the dealer is solvent and financially responsible. Secondly, by the mere act of registration, the state authorities are enabled to keep watch on the activity of these dealers, and to trace those who are engaging in doubtful or fraudulent practices.

As an example of the requirements governing the licensing of dealers in those states which stress this aspect of blue-sky law practice, the Indiana law is cited here. This is of special interest as showing what legitimate investment houses must do in order to do business in that state.

> Every dealer before engaging in business in this state shall file in the office of the commission an application for registration in writing in such form as the commission may prescribe, duly verified by oath, which shall

state the principal office of the applicant, wherever situated, and the location of the principal office and all branch offices in this state, if any, the name or style of doing business, the names, residence and business addresses of all persons interested in the business as principals, co-partners, officers and directors, specifying as to each his capacity and title, the general plan and character of business and the length of time the dealer has been engaged in business. The commission may also require such additional information as to applicant's previous history, record and association, as it may deem necessary to establish the good repute in business of the applicant.

Every dealer shall file with his application an irrevocable written consent to the service of process upon the commission in actions against such dealer in manner and form as hereinabove provided in section 9.

Every applicant for a dealer's license shall also file with his application a bond in the sum of five thousand dollars ($5,000) running to the State of Indiana in such form, if any, as the commission may designate, such bond to be conditioned upon the faithful compliance with the provisions of this act by said dealer and by all agents registered by him. Such bond shall be executed as surety by a surety company having a net worth of not less than one million dollars ($1,000,000) and authorized to do business in this state.

If the commission shall find that the applicant is of good repute and has complied with the provisions of this section, including the payment of the fee hereinafter provided, it shall register such applicant as a dealer.

Upon the written application of a registered dealer and general satisfactory showing as to good character, and upon the payment of the proper fee, the commission shall register as agents of such dealer, such natural persons as the dealer may request.

The names and addresses of all persons approved for registration as dealers or agents and all orders with respect thereto shall be recorded in a register of dealers and agents kept in the office of the commission which shall be open to public inspection. Every registration under this section shall expire on the 31st day of December in each year, but new registrations for the succeeding year shall be issued upon written application and upon payment of the fee as hereinafter provided, without the filing of further statements or furnishing any further information unless specifically required by the commission. Applications for renewals must be made not less than thirty nor more than sixty days before the first day of the ensuing year, otherwise they shall be treated as original applications. The fee for such registration and for each renewal shall be twenty-five dollars ($25) in the case of dealers, and five dollars ($5) in the case of agents.

In their regulations licensing dealers, most blue-sky laws distinguish between "investment companies" which offer securities in their own names, and brokers who merely transact business as agents for others. There is no desire to control the operations of brokers except in so far as they are used to float new securities within the state. Investment companies, within the meaning of the blue-sky laws, include all dealers in securities and corporations making direct offerings of their own securities. The term is not to be confused with the group of companies more commonly termed investment trusts.

In several states, there has been a tendency in the law to favor dealers resident within the state at the expense of those operating from without who send salesmen and other representatives into the state. Thus, the Virginia law, as amended in 1928, provided that securities shall be exempted from the provisions of the law when offered by a licensed dealer, who "must be a regular dealer in securities and must have been in business in this state for a period of one year prior to the date of his application for license as a licensed dealer under this act." Discussing this type of provision, which makes it difficult for outside houses to do business in Virginia, the Legislation Committee of the Investment Bankers Association of America says:

> Forty-six states have some form of law which was enacted to protect the public against misrepresentation, deceit and fraud in the sale of securities. The clearly indicated purpose of such law is to protect the citizens of the state. It is contrary to the recognized purpose of such legislation that such law should become the medium, whether intentional or otherwise, by which unfair competition is accomplished by one class of dealers against another class of dealers. Classifications made by such law should be on reasons that have a legitimate, fair, just and reasonable relation to the purpose of such legislation.
>
> Such discriminations are also objectionable for the reason that they act as a barrier to the proper distribution of sound securities, whereas it is essential to the growth, development and prosperity of the nation that investment funds of the public shall be free to flow in any natural channel when there is no fraud or deception, and that legitimate business wherever located shall have the opportunity of free access to the available capital of the general public in all parts of the country with the least possible burden.

In states where such favoritism is shown to local security dealers, the practice is common for outside houses to sell securities only to such local dealers, rather than to the general public, for these dealers are exempt from the operation of the blue-sky law. Thus, in Pennsylvania, security dealers selling to investors there must be licensed in the state. Unlicensed dealers, in advertising new issues in Pennsylvania, state in their advertisements that "the above offering is confined to banks, savings institutions and trust companies created under the laws of Pennsylvania and to persons and companies registered under the securities act approved June 14, 1923." Thus such regulations increase the business of dealers within the state, but may not conduce to the best interests of investors.

Regulation of Specific Issues

In securing a permit to make a specific issue, the first important task facing the investment banker is to determine whether or not any given offering is subject to the provisions of blue-sky laws in the various states.[1] It is to the advantage of the originating house to make new issues exempt, if possible, as in this way an important cause of delay and a large amount of trouble and uncertainty may be avoided. By keeping these regulations in mind when negotiating an issue, this may often be accomplished.

The first important class of exemptions is government securities, which are generally exempt in most states. This exemption applies not only to obligations of the United States government, the states and municipalities, but also to foreign governments and often to government guaranteed obligations as well.

A second important class of exemptions relates to securities listed on specified exchanges. Often this exemption is widened by a provision that securities senior to these listed securities are exempt also. In both cases, the theory is that these issues have been adequately investigated by the exchange before listing. Thirteen states in 1929 had such exemptions for issues listed on the New York Stock Exchange, and nine for those listed on the New York curb. Public utility securities, including railroad issues, being sold by companies subject to regulation by governmental bodies, also are generally exempted. There are such exemptions in 28 states at the present time.

[1] For this purpose, an up-to-date compilation of blue-sky laws is necessary. Such a service is performed by Clark Boardman's *Blue Sky Laws of the United States*, giving the law of each state, with a digest, in a loose-leaf volume.

The exemption list is frequently, for the large investment banking house, the most important part of the blue-sky law. While conformance to several of the state security laws involves so many delays and uncertainties as to discourage selling effort by investment houses in those states, simple conformance to the exemption requirements eliminates this difficulty. Hence, there is a special advantage in securing such conformance if possible. Thus, many investment trust issues, among others, have been listed on the Boston Stock Exchange because this gives exemption under the blue-sky laws in several states. By listing in Boston rather than New York, two advantages are gained. There is less difficulty in maintaining the market on the smaller exchange, and less stringent regulations govern listing. Listing is but one example of how exemption may be gained for a security.

The tests applied by state commissions in passing on applications for permits for the sale of securities differ, both in accordance with law and according to the known predilections of the state securities commissioner or similar officer given jurisdiction in the application of the blue-sky laws. In Massachusetts, the chief legal test is the character of the principals. Michigan stresses chiefly asset values. Thus, this state forbade at one time the sale of preferred stock of Dodge Brothers, Inc., within the state, after about $1,500,000 of the stock had been sold there, because the book value of the shares based on the balance sheet as published was only $1 per share. Earning power is stressed in Illinois and Wisconsin. Still another test applied is whether or not the issue is speculative, securities of an uncertain character being discriminated against. Finally, there are a number of states having no known policy in granting permits. These rely upon a combination of earning power, asset value and character of management in judging an issue, approval of which is applied for.

Blue-sky law proceedings must be expedited by bankers especially in those states which require preliminary approval of an issue before it is actually offered to the public. This is done in the States of Massachusetts, Rhode Island, Michigan, Illinois, Wisconsin, Georgia and Missouri. In the first two states named, and in Georgia, approval is given as soon as a "notice of intention" to make the issue is received from a licensed dealer. In Michigan, such approval may or may not be forthcoming. Illinois and Wisconsin grant preliminary approval only to securities belonging to the non-speculative class, as measured by the criteria set up in the blue-sky laws.

Final qualification is secured for an issue after the issuing company makes out full papers on forms furnished by the security commissioners. Bankers generally see that these forms are furnished the company, and that no delay occurs in filing them. A requirement that this be done as soon as possible is often included in the purchase agreement.

When securities are sold in violation of blue-sky laws, the latter frequently provide that sales are void or voidable at the option of the purchaser of the securities. In addition, teeth are put into the law by providing fines and prison terms for parties selling securities contrary to its provisions.

The lack of uniformity in blue-sky legislation makes it difficult for the legitimate security dealer, whose prime requisite is frequently speed of operation, to do business in several of the states where the regulations are most severe. In practice, this often means either avoiding those states, or doing business through dealers who are close to the situation there and will be able to get securities through the commission with the least friction and delay. In fact, the personal element enters largely in many instances in licensing securities, the commissioners having confidence and respect for leading dealers in their own state, and being more severe with those from the outside. Efforts to bring about greater uniformity in blue-sky legislation are constantly being made by the National Association of Security Commissioners, a body consisting of commissioners from 37 states who meet annually and keep in constant touch with one another in endeavoring to improve the enforcement of the several blue-sky laws.

Investment Trust Regulation

Greatest uniformity in licensing new issues of securities has been attained in the case of investment trust securities. These issues are a new element in American finance, and therefore there were no provisions on the statute books governing their sale. Hence, the security commissioners have been in a position to formulate their own rules in licensing investment trust officers, and early in 1929 such a set of uniform rules was made public.

In the application for licensing the sale of investment trust securities in the 37 states represented on the National Association of Security Commissioners, the individual trusts are required to fill out a uniform blank which calls for full information as to their organization and personnel. Provision is made for calling for such further information as the case requires, but the following general requirements have been laid down:

1. The securities offered should be in marketable form and negotiable by endorsement.

2. The personnel of the office and management should show a clear record of good business repute, and should be men of integrity and investment experience.

3. The officers, promoters or managers should make an investment of their own funds sufficient to assure a personal interest in the proper conduct thereof.

4. Certain essential fundamentals should be present in the charter or agreement which should be of such character as to amount to a covenant with the investors. Some of these are as follows:

(a) Adequate provision in the charter or trust agreement or like indenture definitely and accurately stating the plan and policy of operation.

(b) Provision for periodic statements of the financial condition of the company, including balance sheet in detail, income and disbursement statement, and, in the case of a fixed trust, an itemized list of investments held in the portfolio, or, in the case of a management trust, a classification of investments held; this information to be furnished the share or unit holders at periodic intervals.

(c) Provision that the capital assets cannot be distributed during the life of the trust through dividends.

(d) Provision for the establishment of reserves and of surplus out of the current net cash earnings from whatever source.

(e) Definite statement as to the cost of management and the expense incurred in the raising of capital.

(f) A clear statement of any privilege accorded the incorporators, officers or managers.

The report of the association's committee on investment trusts says further:

We believe that all States equipped with blue-sky laws can, through a careful analysis of the applications, fairly judge the merits of the various companies that may appear before them to the end that the honest and ably managed companies will not be precluded from carrying on legitimate and profitable enterprises.

We believe that in time the practice of furnishing to investors and prospective investors clear and adequate information which will enable them to judge the management and to know in what way their funds are being handled will tend to weed out the undesirable and loosely managed trusts and leave those institutions which are inevitably to become a more important and ever-increasing factor in the financial growth of the country.

Many proposals have been made to pass legislation to regulate these companies specifically, but up to 1929 no such bills were passed in any state.

In the regulation of public utilities, considerable difference exists in the practices of different states. In the first place, not every state regulates all types of utilities, many leaving this task to the municipalities in which the utilities operate. Thus, Florida regulates only street railways and telephone and telegraph companies. Nearly all the states do regulate through their state commissions electric light and power and gas companies. In this regulation, however, only a limited number of states retain jurisdiction over the capitalization of these companies, requiring approval of the issue of securities. Those which do, according to a recent survey of the Investment Bankers Association, are Alabama, Arizona, California, Georgia, Illinois, Indiana, Maine, Maryland, Massachusetts, Michigan, Missouri, Nebraska, New Hampshire, New Jersey, New York, North Dakota, Ohio, Tennessee, Texas, Vermont and Wisconsin. In a very few other cases, jurisdiction is given over one or two types of utilities in respect to financing.

Anti-fraud Laws

The security laws of New York, New Jersey and Maryland are of the anti-fraud type,[1] in that no attempt is made to set up a securities commission to pass on new issues as made. Instead, a mechanism has been set up to aid the state Attorney-General in prosecuting those who sell fraudulent securities. This is accomplished in New York under the Martin Law, by requiring that dealers file with the Department of State a "state notice" giving information about themselves and the securities they offer. This information is then published in the regular issues of the state bulletin, which thus contains the information on the basis of which the state attorney may proceed against offenders. No more is required than the name, address and list of members of the house doing business as a security dealer, and the name and address of the corporation whose securities are being sold. Government, public utility, bank and other specified classes of securities are exempt from this publication requirement. But this information has in certain cases been of great aid in securing convictions of fraudulent security sellers and reducing the scope of their activities in the state.

The Martin Act authorizes the Attorney-General of the state to bring an action as soon as he has satisfactory reason, based on complaint or otherwise, to believe that fraudulent practices in the sale of securities are to be undertaken. The court then may grant a preliminary injunction and call for the witnesses stated by the Attorney-General to be necessary in the case, and a referee may be appointed to gather additional evidence. Either with or without such examination, "an order or a judgment may be entered awarding such preliminary or final injunction as may be proper."

Efforts have been made from time to time to have the ordinary type of blue-sky law passed in New York State. However, investment bankers oppose it because of the enormous

[1] The new Connecticut law of 1929 largely transforms the former strict blue-sky law of the state into the anti-fraud type of law.

burden it would place on them, since the great bulk of new issues are originally offered in New York. An effort to pass a law placing investment trusts under the jurisdiction of the State Banking Commissioner was successfully opposed, although sponsored by the Attorney-General, because of its blue-sky character.

The chief difference between the blue-sky and the anti-fraud types of securities laws is that the first is largely preventive in character, while the latter is punitive. Blue-sky laws in many instances—although this is on the whole decreasingly true—seek to prevent frauds before their commission by seeking preliminary scrutiny of security offerings and dealers before the actual sale to the public. The anti-fraud law creates a machinery for facilitating the prosecution and making more severe the punishment of those convicted of already having committed such frauds. Obviously, the investment banker finds the latter law is much less hampering to his regular operations.

E. H. H. Simmons, president of the New York Stock Exchange, gives the reasons why investment bankers favor the punitive or anti-fraud type of law as follows:

> Despite the enormous number of elaborate state laws enacted during recent years on security frauds, the security swindler has shown undoubted cleverness in continuing his activities. It is my opinion that essentially preventive legislation against security frauds has in general considerably hampered the legitimate security business without providing any actual or genuine solution to the security fraud problem. Very often just those states which have the most elaborate preventive legislative codes in connection with the issuance and sale of securities there, are the ones which complain the most bitterly concerning the continued ravages committed on the savings of their people by security sharpsters and tricksters.
>
> It is therefore natural that, as far as legislation against fraud is concerned, the tendency has set in almost throughout the country to depend on punitive rather than preventive fraud legislation, and to punish the swindler speedily and severely rather than attempt to construct elaborate legal traps which are as likely as not to cause the most trouble to honest security dealers who are not particularly on the lookout for them. The swindler in securities belongs to the more intelligent class of criminals. He does not engage in swindling operations without a very careful balancing of the risks which he must take as compared with the gains which he may obtain. As a rule, he can successfully elude the legal traps which

preventive legislation has attempted to set for him. But the one thing which will invariably halt him is the prospect of undergoing a speedy and severe jail sentence. There is nothing new or attractive about this program. It is a remedy as old as the Pyramids. Nevertheless, many states today, after vain experiments with preventive legislation, are turning to punitive laws, and where these are wisely formulated and sternly enforced they have invariably proved effectual.

But whatever the specific form which anti-fraud legislation may take, no such law can hope to succeed without the earnest and hearty co-operation of legitimate security salesmen and dealers themselves. It is all very well to create additional anti-fraud powers to be exercised by state officials, or to appoint a commission with regulatory powers and a few rooms and a few clerks in the state capitol. This is only a part of the real answer to the security fraud problem. The state officials who administer security fraud laws rarely have sufficient appropriations to prosecute their work on the scale required. They are compelled to consider only those cases of fraud which are brought to their attention, by the victim of fraud or some party acting in his behalf. The considerable reticence of investors who have been swindled to make a public exhibit of their past credulity in this way, as well as their inexperience in dealing with the legal machinery established to protect them, largely isolates state investigating officers from the swindling activities that they are attempting to abate.

Federal Regulation

Attempts have been made persistently to pass a federal blue-sky law which would establish a securities commissioner in Washington to have jurisdiction over sales of securities by dealers in one state to investors in another. As this would seriously interfere with the business of the New York investment houses now selling in other states, it has not met with favor from them. Thus far, no success has been achieved in passing such a federal blue-sky act, although the Federal Trade Commission has recently been considering the advisability of such legislation. Instead, legislation of an anti-fraud character is on the federal statute books to govern interstate security selling.

There are two series of federal laws governing the sale of securities. The first is Section 215 of the U. S. Criminal Code, which makes it a crime and provides a penalty for using the mails in furtherance of "any scheme or artifice to defraud." (Also U. S. Code, Title 18, Section 338.) The other series of laws are the fraud order sections which authorize the Postmaster General to issue "stop orders" forbidding delivery of mail and payment of money orders to anyone found conducting any "scheme or device for obtaining money or property of any kind through the mail by means of false or fraudulent pretenses, representations or promises." These fraud order sections of the law (U. S. Revised Statutes, 3929, 4041; U. S. Code, Title 39, Sections 259, 732) were first introduced in 1872, and since 1895 have applied to all classes of mail. Unlike the criminal section of the law, the fraud order sections aim at prevention to a large degree, although without involving registration or licensing of dealers.

The Postmaster General acts as a fact-finding officer in connection with fraud orders, and his judgment is held to be final, except that it may be reviewed by the courts where it is alleged to be arbitrary or palpably wrong. However, in order to carry out this work effectively, a large staff of inspectors is needed, and this affords a difficulty because of the cost involved. In 1928, Paul V. Keyser, counsel to the Legislation Committee of the Investment Bankers Association of America, reported that criminal prosecutions were being used more extensively than fraud orders because of this lack of funds. He proposed a special corps of post office inspectors to handle fraud cases, in coöperation with other public and private anti-fraud bodies, such as blue-sky commissioners, Better Business Bureaus, etc.

The federal government exercises direct supervision over the security issues only of railroad and interstate communication companies, through the Interstate Commerce Commission. This body now has more thoroughgoing supervision over security offerings, within its province, than any other similar body in the country. No railroad corporation may issue any securities, except notes running less than two years amounting in the aggregate to less than 5 per cent of the total capitalization of the company, without its approval. The Interstate Commerce Commission has assumed jurisdiction over every aspect of the sale of securities, and has on different occasions changed the price of offering, the method of sale, the amount, the interest rate and the form of proposals for new issues by railroad companies. However, the regulation of railroad securities is a special matter, and there is no reason to believe that similar methods will be adopted elsewhere. Regulation of railroad finance is an integral part of the present-day general scheme of railroad regulation, whereby the government seeks to assure these companies a fair return on the capital investment without excessive burdens on the traveling and shipping public.

Coöperative Regulation

While the state and federal governments have thus established agencies for the regulation of the sale of securities, investment banking interests have organized coöperative agencies of their own to detect security frauds and raise the general standards of practice in the security-selling business. Among other reasons for this coöperative effort is the desire to discourage stricter state legislation through corrective efforts of their own.

The nation-wide system of Better Business Bureaus is one important factor in this situation. Originally developed by the Associated Advertising Clubs of the World, the National Better Business Bureau was organized in 1927 as a separate organization. There are 26 local Better Business Bureaus working with it. This organization is maintained by contributions from leading firms and financial institutions. It keeps extensive files concerning new promotions and doubtful security dealers, and sends out a corps of investigators to check up on these matters. Developing in this way the most complete existing collection of data on security frauds, the Better Business Bureaus make available this evidence to both prospective investors and the legal authorities. Estimates of annual sales of fraudulent securities have run as high as $500,000,000 annually, and the elimination of these frauds would naturally make available an equal amount of money for legitimate investment or speculation.

The Investment Bankers Association of America constitutes a second important agency working to reduce the number of security frauds through an established organization. The legislation committee of this association, while opposed to legislation of a type which burdens the legitimate dealer, has worked out a uniform blue-sky law and has pushed efforts to broaden federal activities in the prosecution of fraud, as well as working in coöperation with the Better Business Bureaus in their efforts.

The stock exchanges are a third important agency for raising the standards of security issuance, through setting up listing requirements. The New York Stock Exchange has been a leader in this respect. In the field of investment trusts, for example, it let it be known in 1929 that only those companies which are willing to publish their full list of holdings at least once annually would be regarded as eligible for listing. This goes even further, it will be seen, than does the Association of Security Commissioners, which asks merely for a classification of such holdings.

Regulation *vs.* Education

While steady efforts have been made to improve and simplify the operation of blue-sky laws, it has been generally recognized that the best protection against security frauds lies in the education of investors. The growth in the investment banking business, with the consequent increasing difficulty of adequately controlling the quality of new issues, has made education of investors more necessary than ever before. The need for education of the many millions of investors who have little knowledge or experience in this field was described as follows by an official of the National Association of Securities Commissioners:[1]

> The surplus-creating ability of this country has scarcely been scratched, and this fast-growing surplus should be protected and encouraged. The large industrial centers of the East do not realize how hugely the agricultural Middle West and Southwest and South have developed in an investment way in the last twenty years. As an indication, it is common experience of Middle West investment dealers to sell in dozens of small villages of a thousand to fifteen hundred inhabitants which invest monthly $10,000 to $25,000 with a single house.
>
> Blue-sky legislation became necessary because of the new situation; but there can be no question that the gradual improvement in this type of law and the building up of trained forces to administer the laws have achieved a great deal in narrowing the twilight zone of the securities faker.

[1] Statement by Jesse V. Craig, president of the National Association of Securities Commissioners, to newspaper men at the convention of the Investment Bankers' Association of America, October 15, 1928.

At the same time, while the securities commissioners feel that there should be a constant improvement and a uniform betterment of these laws, we also feel that the law cannot do everything. It is not a substitute for common sense.

For this reason we are making an effort in our Association to broaden the economic education of our grade and high schools so that the generation coming on will not only know how to make a dollar but will have a better knowledge of taking care of that dollar after it has been earned and has gone into surplus. I've recently appointed a member of our Association to head a committee to establish this educational effort. We hope in time it will be extended to every state in the Union. Some conception of the magnitude of this undertaking can be realized if you will recall that there are about 800,000 school teachers in this country. With several hundred thousand of these giving a small part of their time to the task, the financial illiteracy, now so outstanding a handicap in the economic situation, will largely disappear and the opportunities for the faker be pushed toward the vanishing point.

Such a process of education, therefore, should make further extension of blue-sky legislation, with its hampering effect on the investment banking business in general, less necessary. It may also result in the course of time in substitution of anti-fraud laws for blue-sky laws proper in the larger and richer states, which may thus seek to attract the activity of investment houses to themselves. Also, it may hasten the day when a simplified and uniform blue-sky law will be worked out for those states which feel the need for this type of legislation.

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Chapter XXIII

INVESTMENT BANKING HERE AND ABROAD

Value of Comparisons

As has been seen in Chapter VII on the history of investment banking, our investment banking mechanism has grown very rapidly in response to pressing needs, and the growth has at times been haphazard and unduly influenced by accident and extraneous conditions. Accordingly, there is no reason to think that the present American mechanism or methods of investment banking are either inevitable or stabilized. Rather, continuous evolution and change are its main characteristics; and no one seems more imbued with the desire and need for constant adaptation to new conditions than the investment banker himself, as shown in the work of the Investment Bankers Association of America, directed toward a higher standard of practice and greater efficiency of operation in the security business.

In order to arrive at a proper appraisal of American practice in comparison with that of other countries, it is desirable to review the organization and operation of investment banking in other countries. The number of countries in which a well-developed investment banking mechanism exists is decidedly limited, however. In fact, only in England, France and Germany does the volume of transactions attain an amount large enough to create first-class capital markets where the volume of transactions raises problems similar to our own. In the smaller countries of Belgium, Holland, Switzerland and Austria, there are fairly important international financial centers, but methods there largely reflect those used in the larger centers. Hence, this review of foreign investment banking organization and operation will be restricted to the three largest.

Great Britain

Security Issuance

Investment banking was developed on a large scale in Great Britain before it became a nation-wide and substantial activity in any other country. This was largely because of the early date at which the Industrial Revolution took place in that country. While famous banking houses were built up in Germany and Italy during and after the Middle Ages, it was in Great Britain that investing in securities first became a popular activity, and thus led to the development of a complete investment mechanism.

In England, even more than in this country, commercial and investment banking have been segregated and different institutions provided for handling each. The great British joint stock banks are commercial banking institutions possessing numerous branches extending throughout the country and abroad. They have generally refrained from entering the securities business.[1] It is true that, because of their close contact with the individual investor in their various branches, they have of late been willing to exercise orders to buy securities. However, the banks persist in their refusal to give advice or to take any active interest in the security markets as principals, so that their function is purely the passive one of receiving orders and turning them over to issue houses or brokers for actual execution.

The investment banking houses of Great Britain are divided into two fairly distinct groups: issuing houses like Baring Brothers & Company, Morgan, Grenfell & Company, Higginson & Company and Glyn Mills & Company, and distributing brokers. This division, which separates the wholesale from the retail fields in the security business, permits the broker or dealer who sells directly to the public to be relatively independent in his advice to customers, as he is not tied down in his dealings to a limited number of issues through syndicate par-

[1] The reason for this which is usually advanced is that the joint stock banks have too little capital and cash reserves against liabilities to enter investment banking on a large scale. The chief joint stock banks are the Midland, Barclay's, Lloyd's and National Provincial.

ticipation, as is the case in this country. On the other hand, it does result in a less direct contact between the investment public and business than is the case where issue houses also sell securities on a large scale; and to that extent investment banking has been less effective in developing British industry and building up giant corporations to which leading houses are closely connected.

The issuance of securities in Great Britain, when not done directly by the borrowing government or vendor corporation, is generally carried out either by the large wholesale houses known as "houses of issue," or by promoters who organize a group to sell a specific issue and usually dissolve after their work is done. As a rule, promoters handle the smaller and less desirable flotations, and it has been one of the less fortunate aspects of British finance that, until the last few years, most domestic industrial issues fell within this classification, depriving a large part of British industry of an adequate supply of capital on reasonable terms.

The houses of issue frequently handle a small or medium-sized issue alone, without forming a syndicate of other houses to aid them. Where a syndicate is formed—and the practice is becoming increasingly common—the participants "sub-underwrite" a portion of the issue by agreeing to purchase it at the public offering price, less a commission, as is the case with selling groups here. The sub-underwriter generally pays down 5 or 10 per cent on the amount sub-underwritten. When the offering is made, orders are received from various sources through the regular distribution channels presently to be described, and the managers then announce what proportion of the issue has not been taken by the public, and therefore is subscribed for by the underwriters. If an announcement is made that a substantial proportion of the issue has "remained with the underwriters," the security issued will doubtless immediately sell at a discount. On the other hand, an over-subscribed issue often starts off at a substantial premium. No effort is generally made to peg the price, however, and syndicate members are not expected to maintain the offering price in their sales, as is the case here. The desire is for a free and open market from the start, as British investors do not buy securities for short turns as a rule, and will ignore a price decline of two or three points shortly after the offering date.

The distribution of securities is accomplished with the aid of brokers, who buy and sell for a commission. These brokers sometimes engage in issue work, but this is not the rule. They are found all over the country, and build up lists of clients who have confidence in them. These clients often look upon the broker as a professional man whose integrity and reliability they are assured of. Business is transacted usually by calling on or writing to the broker, and the bond salesman is all but unknown. The broker gets a commission for turning over orders to other houses. Thus, brokers do most of the distribution work on numerous new issues, receiving orders and turning them over to the issue house, receiving a fee for doing so from the latter. The British broker combines in his work the functions of the American stock brokerage house and the retail security dealer. On the whole, however, it might be said that he does less independent analysis of his own, and pays more attention to the quality of banking sponsorship.

The Stock Exchange

Brokers are known as "inside" or "outside," the former belonging to the London Stock Exchange. The London Stock Exchange is different in numerous fundamental respects from the kind of securities market known in this country and typified in the New York Stock Exchange. It has several times as many issues listed, but there is less activity in the exchange as a whole, because of the smaller number of people trading in old issues, especially on a speculative basis. Transactions do not get the full publicity known here, as no stock quotation tickers are maintained, and brokers may or may not publish their transactions, or "mark their bargains," as they wish. The financial papers give a full list of quotations of such transactions as are reported, but do not indicate sales as opening, high, low, close, because they are not reported in that way.

Members of the stock exchange are divided sharply into two groups: jobbers and brokers. The jobber resembles in a way the specialist of the American exchange, except that he has no dealings with the public, spending his time on the floor and specializing in one group of securities in which he stands ready to make bid and asked quotations when requested by the brokers who deal with the outside public. The jobber makes his profit out of the spread between the bid and asked prices he quotes, while the broker charges the client a fixed rate of commission.

One feature of the London stock exchange is the greater use often made of it in the distribution of new security flotations. Many new issues are not publicly offered and sold before listing, as is the case here, but are listed first and then gradually disposed of through the exchange. This resembles the practice followed here with direct stock offerings by corporations to their own stockholders, the distribution of which is facilitated through the exchange, for there stockholders who do not want to subscribe to the new stock may sell their rights to someone else.

The daily settlement of stock exchange transactions practiced in the United States is uncommon to London. London, like most other foreign exchanges, has adopted the term settlement system, whereby purchases and sales are settled twice a month. This permits a great deal of speculation to go on through buying and selling during the period between settlement dates, thus avoiding the absorption of billions in call loans, as has happened in this country. A mechanism has been devised for avoiding making payment in cash for purchases, or delivery of securities against sales, on the settlement date, or "contango," so that commitments may be "carried over" and continue outstanding for long periods of time. Margins to protect the broker must be deposited with him, however, as is the case here. This margin may be considerably smaller, however, as it is retained by him merely as an assurance against loss and represents no real outlay of funds as long as actual payment is delayed.

There are a number of special investment banking institutions in Great Britain which often play a direct rôle in the issuance of securities. Investment trusts, finance companies, insurance companies and large investors frequently join in underwriting for the purpose of getting their investment securities cheaper, pocketing the underwriting profit instead if the public takes the issue. The investment trust and finance company, until very recently, flourished in England on a larger scale than anywhere else, and the bulk of American investment trusts, leaders in the world in size and importance, still often term themselves "British type." However, the true British investment trust makes turnover profits secondary, considering as earnings only regular interest and dividend receipts on security holdings and using profits to write down the book cost of the portfolio. The finance company is more like the American trust, having a more speculative character and often controlling or promoting all kinds of financial and industrial enterprises. Both types of organization freely engage in underwriting activities.

France

Types of Institutions

The French banking system has undergone considerable change since the pre-war period, and at the present time it continues to undergo important modifications, largely in the direction of developing more intensively commercial lending operations along lines followed previously in Great Britain and Germany. The chief characteristic of French banking hitherto has been the unwillingness of most institutions to advance funds freely for the development of domestic industry. Instead, the banks have in the past sought to concentrate on the security business, and therein they have on the whole preferred foreign issues which gave them a wide margin of profit. The purely commercial banking business was left in substantial measure to the Bank of France, which, unlike other central banks, deals directly with the public through a nation-wide network of branches.

There are three important classes of banking institutions in France from the point of view of investment banking. In the first place, there are the great credit banks, including three old-established and powerful institutions with a nation-wide chain of branches—the Crédit Lyonnais, the Comptoir National d'Escompte and the Société Générale. These banks before the war made a large, sometimes the larger, part of their profits by acting as distributors of securities. France has probably a greater number of individual security holders than any other country except the United States. This distribution has been effected largely by the credit banks, with their several thousand branches. The French security-buying public is very docile, permitting the credit banks wide discretion in handling their accounts. Each credit bank branch, therefore, is a retailer of securities, and frequently far more attention is paid to this branch of the business than to the deposit and discount activities. Compensation of branch bank managers before the war was generally based on the amount of securities sold through the branch, and this practice is still followed to a large extent.

As security distributors, the credit banks occupy a foremost position in France. They generally have refrained, however, from doing very much of the originating business as well, preferring merely to take part in syndicates or consortiums headed by wholesaling or originating houses.

The second type of banking institution is the *banque d'affaires,* which specializes in the origination of securities and the long-term financing of industries. This form of investment house participates in the management of industry to a substantial extent, frequently taking permanent stock participations in companies which it organizes or finances. In this respect, it tends to become more than a mere merchandizer of securities, and acts as an investment banker in a full sense, making loans and carrying them itself over extended periods of time until the success of the enterprise or market conditions make the sale of the securities to the public at a reasonable price feasible. The largest of the *banques d'affaires* is the Banque de Paris et des Pays Bas, others being the Banque de l'Union Parisienne, the Crédit Mobilier and the Crédit Français.

The third type of bank is the private banking house owned by an individual or family partnership, and engaged in security origination, foreign trade financing, management of estates and a variety of other operations carried on in this country by the investment house and the trust company. At the head of the private banking houses stands a small group of leading firms called collectively the *haute banque.* The leader among these is the house of Rothschild, which no longer holds its old position of preëminence, but remains a wealthy and influential banking firm. Others are Hottinguer et Cie., Heine et Cie., Mallet Frères et Cie., etc.

The brokerage business in France is organized along continental lines, but with many special features. The seventy brokers on the floor or *parquet* of the Paris Bourse have few dealings with the outside public, transacting practically all of their business on commission for other banking institutions. These brokers are jointly and severally liable in their dealings. In addition, in the peristyle of the Bourse building, a market of nearly equal importance exists. It is comparable with the curb here, and is called the *coulisse,* or side wing. It is subject to far less stringent regulations than the *parquet.* The term settlement system is in vogue in both parts of the stock exchange on a large number of securities, thus avoiding the tying up of large amounts of credit in stock exchange loans, as is done in the United States.

Investment Banking Policy

Because of both the conservatism of the French investor and his implicit confidence in the judgment of the credit banks, obviating the general need for security salesmen,[1] the cost of distribution of securities in France could well be perhaps the lowest in the world. Much criticism has been leveled at the manner in which the credit banks partly abused this opportunity before the war, neglecting the development of home industry and putting out in rapid succession numerous second- and third-rate foreign loans, including billions of francs of Russian securities of all kinds. The desire of the government to use the export of capital as a medium for gaining political influence furthered this policy, and resulted in a severe shock to the French investment market during and after the war, with the wholesale defaults of such countries as Russia, Mexico and the Balkan States, in which the bulk of French foreign

[1] French banks do have agents corresponding to the "new business" men of our banks, who seek investment as well as bank accounts. They are called *commissaires.* Having secured an account, however, their function ends.

investments had been placed. Investors also sustained enormous losses through the depreciation of the franc. The credit banks generally frowned on stock investments for their clientele, which would have offset part of the loss resulting from the decline of the franc.

The tendency in recent years has been toward a more aggressive commercial banking policy, especially on the part of the *banques d'affaires,* which had to enter this field after the war because of the practical cessation of the foreign loan business. At the same time, more interest in domestic investment banking transactions has been taken, including the formation of numerous holding companies to advance the cause of industrial and public utility consolidation in France, a country in which the combination movement was singularly backward. The small investor, whose dependence on the credit bank has continued, has turned to French government securities as the major commitment for his surplus funds. After 1926, France was in a position to resume her former important place as an exporter of capital, but heavy taxes on the income from foreign securities hampered this movement.

Germany

The Great "D" Banks

The German banking system, in contrast to the British, is dominated by a single type of institution which performs virtually all banking functions in one organization. This so-called continental type of banking is similar to what is known as "department store banking" in the United States, where the leading metropolitan commercial banks are developing along lines long familiar in Germany.

The "D" banks, including the Deutsche Bank, Disconto Gesellschaft, Darmstadter Bank and Dresdner Bank, combine the functions of commercial banking along branch banking lines, investment banking in all its aspects, trust work, security brokerage, etc. We are interested here primarily in their investment banking functions.

The German banks, plentifully supplied with capital and managed by ambitious and energetic boards of directors, have also assumed the rôle of industrial promoters in large part. While the British joint stock banks sought to restrict their operations to working capital requirements of industry, and the French credit banks favored foreign government loans for their customers, the great German banks took the leadership in the foundation and amalgamation of public utility and industrial enterprises, and are largely responsible for the industrialization of Germany after 1870. Whereas in the United States banking may be said to have been the handmaid of industry, in Germany the banks were the masters of industry. They have also encouraged widespread public stock ownership, especially of industrial shares.

Taking so important a part in the management of industrial enterprises, the "D" banks, and a number of smaller but similar banking institutions, also assumed the dominating rôle in the origination of new security issues. In this function, the banks competed with a number of private banking houses, many of them of long standing, such as the firm of M. M. Warburg & Company of Hamburg, Mendelsohn & Company, Rothschild, etc. As with the *banques d'affaires* in France, the "D" banks and the private banking houses in Germany often have kept purchased securities in their portfolios for considerable periods of time before attempting their sale, and in general have regarded their function as being much more than the mere buying and selling of securities for a merchandising profit.

In the selling of securities, the "D" banks and the other large commercial banks exercise a leading part, operating through the thousands of branches they have scattered throughout the country. As elsewhere in Europe, the security salesman is practically unknown, the bank officers dealing directly with the local clientele at the branch office. Much of the selling is done through the medium of order blanks prepared in connection with the security offering list of the bank. These blanks are obtained by the customer at the branch office and, when filled out, become orders which are executed generally through the main office. The large private banks do a great deal of direct selling to larger clients.

An interesting feature of German security selling is the recognized existence of an "investment guaranteed" market. In this country, as has been seen in Chapter XVIII on syndicate selling operations, the sale of a new issue below the offering price on an investment guaranteed basis is considered an abuse. In Germany, it is regarded as a valuable device whereby the banks can favor permanent investors who will assure more or less final distribution of the issue as against speculators and short-term holders. In publishing their offering lists, the banks often quote two prices for each issue, one the regular price and the other reduced by from ½ to 5 points, depending on the issue, on an investment guaranteed basis, in which the buyer promises not to dispose of the issue within six months or so.

Stock Exchange

Germany has a number of substantial stock exchanges, but they are organized and operated for the most part along similar lines, and that of Berlin has assumed a dominant position. Hence, the discussion here will be restricted to the latter.

The Berlin bourse has no limit on its membership, anyone acceptable to the authorities being able to join upon payment of the annual fees. The bourse is regarded as a government institution, and is under close public supervision.

There are three kinds of brokers operating on the bourse. The "sworn broker" corresponds to our specialist to a degree. His operations, however, are under close supervision by both exchange officials and government representatives, and his duties are looked upon as involving special public responsibility. He receives orders from the other members of the exchange and fixes the quotation in accordance with buying and selling advices from them.

The second type of bourse member, the "free broker," acts for others in the main, having little contact with the public. He executes orders received chiefly by the banks. "Free brokers" often eke out their activities with some independent floor trading. Finally, the banks and private banking houses take an active interest in the bourse, the larger ones having several representatives of their own on its floor. It is these banking members who receive orders from the public, and carry margin accounts for traders.

There are three types of trading on the Berlin bourse. Most of the securities listed thereon, although in the main the inactive ones, are dealt in on a "cash" basis. The brokers and bank members present their orders to the sworn broker, who then indicates on a blackboard with plus or minus signs the trend of these orders. Based on these indications, floor traders and others place additional orders, and finally the sworn broker fixes the official quotation of the day at which orders are filled, prices being fixed to include the largest number of bids and offers. In the second place, there is "variable trading" in many stocks, where the opening and closing prices are officially fixed as above, but where buying and selling goes on much as on the New York Stock Exchange the rest of the session. Thirdly, there is trading for future delivery in a limited number of stocks, these generally being the most active and accounting for the bulk of daily transactions. Settlement for these transactions is arranged monthly, with arrangements for a carry-over.

Other banking institutions carrying on investment functions in Germany are municipal and coöperative savings banks, which have gathered vast sums and purchase gilt-edge securities; and state, provincial and private mortgage banks for real estate financing.

Comparisons with American Conditions

Differences Between American and Foreign Practice

There have grown up a number of outstanding differences between investment banking in this country and in the leading foreign capital centers. Perhaps the most important difference, as far as the individual investor is concerned, is the large role played here by the bond salesman. The bond salesman has established personal contact between the investment banker and the purchaser of securities, and thus has been very important in pushing the development of popular investment. His function in the past has been a vital one, and to the profession of bond salesmanship is unquestionably due, in considerable measure, credit for the rapidity with which the American investment market has grown.

In France and Germany, the well-articulated branch banking system which prevails has permitted personal contact to exist between the client and the bank without the mediation of salesmen. The American small-unit banking system, which has tended to keep local commercial banks out of the security business, is thus in part responsible for the presence of and need for security salesmen in investment banking here.

On the other hand, the bond salesman in this country has been and is today often motivated by factors which in the long run are not altogether sound. His eventual objective is to sell securities, and in order to increase his sales volume there is strong temptation to switch investors frequently from one issue to another equally or even less desirable. Again, the salesman is interested primarily in selling new securities, and therefore he will normally prefer to sell a new and perhaps unseasoned and less desirable issue rather than an outstanding one on which he will make no commission. Doubtless, individual salesmen exist in large numbers who do not permit these interested motives to dominate their activities, but the temptation is strong for all to do so. Also, the same motives operate to some extent under any system of security selling.

But the individual bond salesman is not alone responsible for the substantial lack of disinterested advice available to the American investor from his investment banker. The fact that the security retailers play so prominent a rôle in the origination of securities, and that most of them combine retailing and wholesaling functions, results in most security houses having a limited number of favored issues for sale. To push these issues is not always consistent with giving wholly disinterested advice to the security buyer.

Compared with foreign practice, we find the British capital market organized to give the individual investors much more disinterested advice. The broker often makes about as much on an old as on a new issue. In France, conditions are nearer the American in character, the branch bank manager often acting much as does a bond salesman here in seeking to push issues sponsored by his house. In Germany, the big banks have such wide interests that they can, without damage to their own interests, give clients fairly independent advice on securities.

A second important characteristic of American investment banking which differentiates it from foreign practice is the frequently artificial character of markets for new issues of securities. Pegging of quotations exists to some extent all over the world. Only in this country, however, is it so inevitable and regular a thing on new issues of securities. The broad geographical expanse of the United States, and the speculative flair possessed even by more conservative investors here, account for this custom in large part. It takes longer to distribute an issue here than abroad, and during the process of primary distribution pegging is generally regarded as necessary. Furthermore, nowhere else does the bulk of investors pay so much attention to quotations, as against stability and safety of income over a period of years. A British investor may not care much if his bond sells four points below the subscription price at the opening of trading, as long as his return is satisfactory over a period of years. Here, when a security declines soon after issuance, the tendency is strong for purchasers to throw bonds overboard and take whatever loss has been incurred as soon as possible, rather than run the risk of further price depreciation. On the other hand, perhaps nowhere else do so many people like to "hop on" when a promising issue is being publicly offered for the first time, in order to make a "scalping profit" of a few points, as in England. The scramble for promising new offerings of the speculative type results from the attraction of such issues to speculators who cannot trade on margin as easily as here, and who consequently prefer to buy new issues on which only a small initial payment at the time of offering may be required.

In England, pegging of the market is not usual. In France, it has been done on numerous occasions, although there the market in new issues does not generally show much activity.

Stock Exchange Organization

A third characteristic of the American market is the peculiar organization of the stock exchange, with its daily clearings. This involves a vastly greater amount of clerical work than the European term settlement system, and also ties up a much larger amount of bank credit in the shape of brokers' loans. On the other hand, there is a possible advantage in a system which gives the broker an income for holding a speculative security, through the payment of an excess interest charge on the debit balance. This gives the broker a somewhat smaller motive for inducing customers to turn over their speculative holdings rapidly.[1]

Another vital feature of the security market in this country is the greater volume of speculative and manipulative activity which is carried on. There is a larger number of individual speculators in the American market than in any other country, and the range of stock price movements is generally wider. At the same time, there is good reason to believe that pool operations and other manipulative phenomena are much more highly developed than is the case elsewhere. Conditions here are specially favorable to such tactics. Among the factors which tend to foster speculative activity are the existence of a large investment demand which sharply cuts down the floating supply of stock issues; the highly developed call loan market; the large number of stock exchange brokers, which make competition for business, especially of the big speculators, so keen as to result in a relaxation of the usual margin requirements in their favor; and, finally, in certain instances the fact that specialists on the floor of the exchanges are not segregated and specially supervised, as is the case in London and Berlin. The specialist, knowing intimately the condition of the market in any one issue, since he receives the bulk of the buying and selling orders in it, is in a specially favorable position to direct or participate in speculative manœuvers.

Another important characteristic of the security markets here has been the large amount of direct public investing in common stocks which has been the case in latter years. The European investor generally has preferred government securities and corporate bonds, although Germany and, to a greater

[1] This gain is largely offset in many cases, however, through the customers' man's desire to show a larger amount of business done by him, and results from interposing between the brokerage house and the customer an individual who has assumed an advisory capacity, in addition to executing the routine task of receiving and recording orders.

extent, Belgium, have been partial exceptions. Investments in common stocks in England, consisting in the main of foreign shares, were made to a large extent through the medium of the investment trust, while in France and Germany the banks have acted in many cases as large investing organizations in equities. In this country, the rank and file of investors have long shown interest in common stocks, although since the war this tendency has been far more pronounced than ever before. At the same time, indirect investing through the formation of investment trusts and trading organizations has developed on a large scale.

Tendencies in American Investment Banking

During the past few years, a number of clear-cut tendencies have developed in American investment banking which promise several changes for the future.

The first vital change is the entry of the American commercial bank, the most important factor in our financial institutional organization, into the investment banking field. This has been accomplished, as has been seen, through the establishment of bond departments, through the formation of allied security and investment organizations, and through the investment of the bank's resources, resulting from both time and, to a lesser extent, demand deposits, in bonds. There are in excess of 27,000 commercial banks in this country, and their wholesale entry into the investment banking field naturally expands the mechanism of the capital market in this country enormously.

Integration of financial operations of diverse character within a single institution is one of the outstanding characteristics of the day. Numerous investment banking organizations exist today which are both security dealers and brokers and, in addition, have large affiliated investment trusts which bring within their control great amounts of the capital of their regular clients and others, for the management of which they take responsibility. Similarly, the commercial bank does a security business; the larger ones have an investment affiliation, and many commercial banks arrange the execution of commission orders for clients and help carry stock purchased by advancing loans on it as collateral.

A second important change is the multiplication of indirect investing organizations in this country. The investment trust movement is a direct expression of the public need for supervision and organization of its investment activities, especially in view of the pronounced tendency to favor stocks as against bonds as a medium for investment, which has in turn profoundly affected the position of investment banking institutions. The old-time bond house in its pristine form is passing away. Instead, we have what may more properly be called a "security house," dealing in stocks as much, and sometimes more, than in bonds. Of course, the relative importance of each of these two types of securities will vary with the state of the money market and the prosperity of business, but the general tendency in recent years has been to favor stocks. For this reason, the investment trust in its numerous forms, designed to create investment or speculative agencies freed from legal restrictions to which the old-fashioned investment organization like the savings banks were subject, has become the most rapidly growing financial institution of the time.

Finally, American investment banking has become conscious of its important rôle and the need for increasing its efficiency and effectiveness. There are large and small houses in the field, and the number of individual financial organizations engaged in selling securities in one way or another is estimated to be above 7,000. Hence, there is room here for the application of the same spirit of coöperation which has characterized commercial banking and the four hundred odd other lines of activities in which trade associations have been formed.

The efforts of the Investment Bankers Association of America to set up a new standard of ethics which will curtail cutthroat competition and eliminate practices that injure the interests of the borrower and investor represent the coming of age of the investment banking business. It means that many of the abuses which have entered into the business during the preceding period of rapid expansion will be eliminated, and also that in the future such abuses will be less likely to arise. Finally, the exchange of experience between members of the association tends to build up a body of knowledge which will make investment banking less haphazard and more exact in the future. To cite but one example of this, the application of cost accounting for the purpose of determining unit costs will make price fixing on new issues much easier and subject to less miscalculation. This association activity is peculiarly American,[1] and nothing quite corresponding to it is to be found among investment bankers in Europe.

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[1] The Investment Trust Association in Great Britain represents a similar development, but it is restricted to one special phase of investment banking activity.

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