INVESTMENT TRUSTS
AMERICAN EXPERIENCE

BY

WILLIAM HOWARD STEINER, Ph.D.

Associate Professor of Economics,
College of the City of New York

NEW YORK

ADELPHI COMPANY

PRINTED IN THE UNITED STATES OF AMERICA
BY THE VAIL-BALLOU PRESS, INC., BINGHAMTON, N. Y.

To

MY MOTHER

CONTENTS

PREFACE

Within the short space of five years, the American investment trust has stepped from a place of relative obscurity to the forefront of discussion in financial circles. The facts, today, are well known. Material prepared by individual trusts is available in great quantity, and the salient facts are summarized in the two manuals that have been published in this field. But understanding of the movement calls for far more than the mere facts—it requires interpretation as well. While it is still too early in the history of the movement to be definitive, much is already clear as to what the trust is, the lines along which its development is proceeding, and how it came to follow these rather than other lines. Such analysis the present work seeks, as far as is possible at the present writing, to make.

While the investment trust movement has attracted widespread attention for its own sake, it has a wider significance also. Placed in its broader setting, it provides a problem in corporation finance and investment. It represents an attempt, in a new field, to apply old and well known financial devices, modifying them to meet the needs of the particular problem here faced. And it represents an attempt to carry over one country's devices to another, modifying them again as necessity dictates. It thus affords a laboratory, so to speak, wherein to observe the evolution of financial devices and practice in a new field.

The treatment thruout aims at constructive understanding. It seeks to explain and to suggest, rather than to criticize. Such critical analysis as is made represents, not an end in itself, but a means towards an end—that of sounder practice. And it is designed to be purely objective and scientific, not personal. Investment trust managers as individuals need no defenders. Concentrating its attention upon the American movement, it discusses British practice incidentally, in order to afford a clearer understanding of American development, rather than for its own sake.

The information on which the study is based has been drawn from a variety of sources. Published discussions and trust literature have been supplemented by conferences here and abroad and by practical work for various trusts. Both in the United States and in England and Scotland, those interested in the investment trust movement—far too numerous, unfortunately, to mention here—have been uniformly courteous and helpful. The many sided character of their interest—including as they do attorneys, bankers, security dealers, financial writers and government officials, as well as trust executives—has, it is hoped, left its stamp upon the present treatment.

Special acknowledgment is, however, due several gentlemen. Dr. J. I. Bogen, Financial Editor of the New York Journal of Commerce and Assistant Professor of Finance at New York University, has kindly read the entire manuscript and made many helpful suggestions. Dr. A. H. Stockder, Associate Professor of Business Administration at Columbia University, has performed a similar service for the manuscript of Chapter I. Messrs. D. M. Touche, of the firm of Geo. A. Touche & Co., Chartered Accountants, and director of the Trust Union, and H. H. Dick, of Thos. Skinner & Co., have kindly read the manuscript of Chapter II, dealing with the English and Scottish movement. Mr. Duncan Merriweather gathered data for part of Chapters II and V, while Drs. J. M. Chapman, Assistant Professor of Banking at Columbia University, and Ivan Wright, Associate Professor of Economics at the University of Illinois, prepared tentative preliminary drafts of Chapters

XI and VIII, respectively. My former secretary, Mrs. Jean P. Sayers, has been of great aid in connection with the mechanical phases that bookwriting involves. At the same time, of course, the author is alone responsible for all statements made.

W. H. Steiner

November 4, 1928.

INVESTMENT TRUSTS

AMERICAN EXPERIENCE

CHAPTER I

WHAT THE INVESTMENT TRUST IS

One who attempts a rigorous definition of the term "investment trust" is apt to run into numerous difficulties before he has gone far. "Pure" trusts exist side by side with hybrids of all kinds, which often embody certain investment trust characteristics but include also other features of an utterly alien nature. The trusts, themselves, represent all shadings and differ from some other organizations in degree rather than in kind. The underlying idea is not new, although the peculiar forms it has taken and the growth it has achieved, are. Well might the Attorney General of the State of New York, in the final draft of his proposed legislation, early in 1928, finally avoid entirely any attempt at strict legal definition.

CHARACTERISTICS

The investment trust is an organization wherein investors coöperate by contributing, perhaps on different terms, to a common fund. By so doing, they expect to receive greater returns in relation to safety than they individually could achieve. They expect a more effective investment policy to be employed than they individually could develop. In other words, they seek, thru the trust, to achieve the best possible application of capital for the mutual benefit of those associated in the enterprise and contributing that capital.

The salient features of the investment trust are five-fold:[1]

1. It is an agency which combines the funds of many investors, in both large and small amounts.

2. It applies these funds to the purchase of securities.

3. It purchases securities for investment only and avoids the responsibility of direction or control of other companies.

4. It holds a variety of securities, in an effort to achieve diversification for the protection of both principal and income.

5. In most investment trusts, it supervises the portfolio continuously, so as to achieve a good average yield and, at the same time, more or less incidentally turn over the securities held, in order to realize capital gains and to avoid capital losses. It seeks to profit thru judicious investment and reinvestment in a diversified list of securities.

STRUCTURAL FEATURES

From the purely structural point of view, the investment trust represents one species or form of securities substitution. The trust substitutes its own securities—which it sells to investors—for those of other companies which it holds. This is true whether the substituted securities issued by the trust are simply certificates of participation of a single kind—by whatever name known—or whether they are complex, and comprise several different kinds, such as bonds and other creditor obligations, as well as proprietorship securities such as preferred and common stock.[2] In

[1] Compare Robinson, pp. 5–6, 264.

[2] A trust which issues more than one class of securities can, of course, acquire capital for a lower rate than that at which it employs the funds, thereby obtaining an increased yield on its junior securities.

either case, the trust's securities serve to bind together participants in the common undertaking of acquiring securities of other companies. It is created for this sole purpose.[3]

The very fact that under this system two securities are issued to represent an ultimate investment in one project—the security of the trust and the security which it holds—involves extra work and extra cost. The extra cost of the specially created intermediary is justified, from a social point of view, only if the community receives a real service by reason of the substitution. The mere fact that the sponsors of the trust, whether managers or salesmen, get jobs, while practically potent, affords insufficient grounds and is unimportant.

FUNCTIONAL FEATURES

Investment trusts are but one kind or class of securities substitution companies. They are organized primarily to hold the securities of other companies as investments, not to resell or turn them over shortly; to participate in these other companies, but neither to dominate them nor, on the other hand, to aid them. The trusts seek to maintain an investment position independent of the companies whose securities they hold—aloof, critical, dispassionate. Through the diversification of their security holdings they further seek to apply the insurance principle of distributing a risk over a large field instead of concentrating it in a few hands. But this is merely one phase of their work, and to magnify diversification into the cardinal principle of investment trust operation, is to distort the picture.

[3] Some companies, of course, in particular public utilities and railroads, undertake the work as incidental to other operations, and are of a hybrid character.

Investment trusts are thus sharply to be distinguished from the two other classes of securities substitution companies. Unlike investment trusts, holding companies are organized to control other companies by holding all or a majority of their stock. Such holding companies employ the principle of securities substitution for purposes of control, a thing which the investment trust avoids. Just as fundamentally do investment trusts differ from financing companies which are organized to promote and finance new enterprises. These financing companies are designed to introduce new companies—generally only a few—to the public under their auspices until the public is ready to absorb the securities of the new companies on their own merits. Often the financing companies specialize in one industry such as rubber, tea, oil, shipping, mining, railroad, traction or electric power, and in effect carry securities more or less unsalable at the moment, pending their later resale. Some British companies of this type also carry on actual business operations within their chosen field, such as the conduct of tea or rubber plantations.

The legal or juristic sense of the word "trust" should be distinguished from the economic. From the former point of view, the word "trust" in the name "investment trust" may seem a misnomer. While some British trusts act in fiduciary capacities, such as trustee, registrar and secretary, these activities in such cases are side lines, and are not carried on by investment trusts in the United States, which go no farther afield than participating in underwriting new issues. In fact, the American investment trust bears no resemblance to the American trust company. Their work is basically different.

The word "trust" hearkens back to the accidental fact that the early investment trusts were organized as common law trusts, instead of as corporations. It has persisted, despite the change, just as the word "trust" continues to be applied in every day speech to any large scale business enterprise suspected of monopolistic leanings, because the old Standard Oil and other interests adopted this form of business organization about half a century ago. Some investment trusts, in fact, are still so organized, but the vast majority make use of the corporate form of business organization, and have boards of directors instead of trustees. At the same time, the word "trust" is useful in that it emphasizes the responsibility which devolves upon the management of the trust. They are in many ways trustees for the investors who entrust their money to them rather than merely directors of a corporation.[4]

ECONOMIC BASES

To what is the growth of this investment intermediary due? The service, it should be noted, is by no means new. In fact, the Augsburg bankers in the 16th century performed a somewhat similar function. Many people could not use their savings directly in business themselves, nor did they wish to leave them idle. Loan of them at interest would run counter to the canon law. Therefore the savings were turned over to the Fugger and other merchant bankers, and the investors became partners in theory. Already in 1485, in fact, effort was made to provide for a proportional limitation of liability by statutory enactment for those who participated in enterprises under such conditions. Subsequently, of course, the stock company de-

[4] A contrary view has been expressed recently by Geo. V. McLaughlin before the National Association of Securities Commissioners, by Frank C. Mortimer before the trust company division of the American Bankers Association and by the Investment Trusts Committee of the Investment Bankers Association. They favor some such term as "investment companies" and the latter body has changed its name accordingly.

veloped, with direct purchase of securities by investors, rather than indirect purchase and holding through the merchant banker.

The more widespread the growth of the capitalistic system, the more intricate the problems of investment become. The system, to be sure, standardizes the forms of investment, and seeks thereby to attract scattered savings in huge amounts. But it vastly complicates the problems of investment. The very multiplicity of opportunities which it opens, for participation in enterprise on different terms adapted to different tastes, bewilders the saver. He is apt to invest without due regard for his needs. In part he is unable to judge security values accurately. Even if he does, he is either apt to buy more safety than he requires and get less than an adequate return, or else to buy less than he requires and assume too great a risk. Especially is this true where considerable diffusion of wealth exists, and many savers are small and inexperienced.

As the capitalistic area increases, the investor's difficulties are complicated by the necessity of laying out his funds abroad. A country, like England during the last century, develops its home resources, supplies foreign countries' needs for goods, and soon finds it necessary to export them capital—to take payment in securities rather than in goods. Or, as in the case of the United States from about 1900–1915, the nation pays interest to older nations for their previous assistance in developing its resources, but is itself exporting large amounts of capital to other quarters of the world. This means that capital supplied by the older increasingly develops the newer nations. But distance and unfamiliarity, varying currencies, regulations, business laws and languages provide a further barrier to investment. Hence the so-called creditor nations need to develop intermediaries which assist in placing funds abroad, to take advantage of the higher interest rates without succumbing to the real or fancied risks involved.

The investment trust has been an important intermediary in solving the investor's problems. It is a product of certain economic conditions. It arises only in countries that are approaching economic maturity. It further requires a considerable body of more or less inexperienced savers, unable because of lack of opportunity to employ their funds directly in business undertakings.

Thus it is that Great Britain is the home of the investment trust, and the trust is credited with having strengthened London's pre-war position as financial center of the world. She experienced demand for capital as the Industrial Revolution developed, but the smallness of the country limited such home demands. Moreover, she has been for centuries a great colonial power. She was the world's greatest lender from the close of the Napoleonic wars until the United States stepped to the forefront, and we, in fact, owe much of our economic development to the capital placed with us by British and Scottish trusts.

But elsewhere other forms of investment intermediary developed. France has displayed economic self sufficiency in considerable degree, and has never been a great colonizing nation. The foreign obligations her investors bought were largely governmental obligations, and were purchased on a quasi-political basis. The French, Belgians and Swiss, in fact, created mostly so-called "assumption companies," and found capital through the banks. Germany and the United States, before the war, could use much capital and interested themselves in holding companies and other devices concerned rather with raising capital than with providing investment outlets.

Today the United States stands at the threshold, and has interested herself in investment organizations as well as financing adjuncts. We have many industries overbuilt, with equipment in them ample to supply needs a generation hence. At the same time, we have a constantly increasing amount of funds seeking an investment outlet. These must find a foreign, not a domestic use, if we are to avoid still greater saturation. Mere domestic use would result in security price inflation. But the intermediaries face one serious handicap. The American investor has in large measure been accustomed to have more or less speculative securities offered directly to him and to select himself from among them (whether he understood them or not), instead of relying upon an intermediary.

INVESTMENT SERVICES

What investment services does the investment trust render these savers? Selection of a good investment, as Dewing points out,[5] involves selection of one in which the actual rate of return yields a pure business profit above the sum of the pure interest rate prevailing at the time and the premium necessary to offset the risk of loss involved. Investment science, moreover, has made great strides in recent years. It has called attention to the relative merits and disadvantages of the several classes of securities, as well as to the advantages of changing investments as financial conditions change. Practical applications of these ideas are legion. Common stocks bought auspiciously may be made to show substantial gains, while in declining markets the capital gains may be held by shifting to bonds, to cite only one illustration. Better understanding, in short, is afforded of the ways in which to achieve a higher and more stable income, as well as a more

[5] Financial Policy of Corporations, rev. ed., New York, 1926, Book VI, Chs. 1 and 2.

secure principal, together with opportunity for appreciation in both principal and income.

What chance has the individual investor to make use of these principles, much less to obtain the detailed data and analyses for the many individual issues that compete for his favor? Moreover, even if he did, his funds would generally not be large enough to permit him to buy advantageously nor, even more important, to diversify and thus avoid putting all his eggs in one basket (even though the capitalistic organization of production itself affords some diversification). The investment trust enables him to buy in larger lots, hence more advantageously, and to divide even a minute sum over many issues. It enables him, by "investing by proxy," to hire skill and experience coupled with good sources of information, to lay out and watch over his funds. As Powell states:[6] The finance, investment, and mortgage trusts, however, remain as standardized investors, in that it is their constant and very successful endeavor to raise the rate of return on their money without infringing the canons of financial prudence. Their invocation of the law of average makes them self-insurers: so that inasmuch as they possess a specialized skill, the risk is taken by those who are capable of measuring it. "To confine speculation to those who have aptitude for it, and to discourage stock and commodity gambling, is one of the economic problems of the day." There is only a minor element of gambling to be considered in the case of the trust companies: but there is an undeniable assumption of a legitimate (and socially beneficial) financial risk on the part of those who have aptitude and training for it. The great trust and investment companies, again, are a class of strong holders, performing a fruitful function at all times, but most of all in

[6] The Evolution of the Money Market, 1385–1915, London, 1915, pp. 477–478.

days of market stress. A trained investor (whether an individual or a corporation) is a "good" holder, whereas his untrained nervous confrère is a "bad" one. The difference between the accumulation of stock in "good" hands or "bad" may be of great moment to market conditions, and consequently to the price of securities, in the hour of stringency. It may mean the difference between stress and crisis, or between crisis and panic. The cool heads of the managers of a great trust company are not turned by crisis or by the threat of panic. They do not rush to throw everything on the market. They are more likely to steady it by timely purchases. As they are in constant communication with the other controlling influences of the Money Market, their trained and fearless coöperation is one of the bulwarks of the financial fabric itself.

Hence, it is often stated that the well managed investment trust tends to render certain socially important services. Especially where knowledge of securities is limited, as on foreign securities, such indirect participation avoids the hazards of direct participation. It gives the small saver's funds the same opportunity as the large saver's, and stimulates saving. By increasing investment yield, it tends to keep the small saver out of the hands of dealers in fraudulent securities and out of security speculation on his own account, hence to avoid these losses and social waste of capital,[7] as well as interference with security market operation that distorts prices. Furthermore, the investment skill employed recognizes better actual security values and reduces over-valuation of gilt-edged securities by shifting demand elsewhere, while it meets the demand for funds from capital poor sections offering an excessive premium. Over a period of time, the investment trust buys

[7] The interplay of professional and economic forces on the stock exchanges renders speculation increasingly difficult.

when prices are depressed and sells when they are buoyant, hence steadies security prices, which is exactly the opposite of what the rank and file of investors and marginal speculators do. It thus becomes a valuable counterbalance and may in time constitute an agency to bring the market more under the control of the investing public at large. Finally, it is consulted at an early stage when a company is in difficulties and can take appropriate protective measures, and it often participates in underwritings. Thus the investment trust not only aids the saver but also, where well established, as in London, becomes a strong and stabilizing factor in the securities markets.

RELATION TO OTHER INVESTMENT INSTITUTIONS

Other institutions, it is true, offer a more or less similar service. A century ago in the United States, the small man was not left at the mercy of his own unaided judgment, but the mutual savings bank was developed to aid him. Wealthy individuals gave freely of their time and experience in order to benefit their less fortunate brethren who brought their deposits to the mutual savings bank. While they are still closely restricted in the investments they may make, these banks have today relinquished their original philanthropic character in considerable degree. Other banks and trust companies also operate savings and thrift departments. Building and loan associations which lend to home builders compete actively with savings banks and departments for the funds of small savers. The life insurance company affords an opportunity for saving in both large and small amounts.

The investment banker has always proffered his aid to the larger investor in selecting securities adapted to his requirements, but has been viewed with some suspicion as an interested party.[8] In recent years, a new profession, that of investment counsellor, has arisen, which offers advice for a fee, while the trust company has stressed so-called living trusts, either limited on the whole in their investments as are savings banks or entirely discretionary.[9]

The investment trust today competes with all these organizations. As yet there are no exact limitations recognized as to the investment policy which each should follow and the appeal which each should make. Complaint is made, for example, of the competition which building and loan associations offer to savings banks, but there has been no serious attempt made to envisage the entire investment field and to consider carefully the exact scope of service which each of these institutions renders. Sooner or later this must be done, especially if attempt be made further to regulate by law the activities of various of these institutions.

BIBLIOGRAPHICAL NOTE

The literature on investment trusts is quite voluminous, especially if account be taken of reprints of the more prominent articles and addresses in the financial press and of brief articles appearing therein. A considerable number are prepared by the trusts themselves or by executives of the trusts. In order to assist the reader, there is given here a selected general bibliography of books and articles. To some of these books, reference is made at the

[8] He has often employed the slogan "Be your own investment trust." The small dealer, especially, who sells his customer an investment trust security, makes but a single sale, hence a single commission, whereas if he watches over his customers' holdings himself, he may suggest trades and make repeated sales, each carrying its own commission.

[9] A most interesting discussion in trust company circles of late has been whether or not they should favor the pooling of trust investments. In other words, should the trust company, besides or instead of administering separate trusts for different individuals, operate a sort of investment trust, in which it would sell participations? See Chapman, J., address before the Mid Continental Trust Conference, Sept., 1927, and Smith, J. G., in American Bankers Association Journal, Dec., 1927, pp. 439 ff.

close of the successive chapters, as well as to selected discussions of a specialized kind which are not mentioned at this point, but only at the close of the appropriate chapter. For the sake of convenience, there are added here a list of current newspapers and periodicals which have devoted special attention to the subject, a list of two more inclusive bibliographies, and a list of collections of investment trust data, both British and American.

BOOKS AND REPORTS

Attorney General of the State of New York, Investment Trusts, A Survey of the Activities and Forms of Investment Trusts with Recommendations for Statutory Regulation by the New York State Department of Law, 1927, pp. 132.

——, Supplemental Survey of Investment Trusts, 1928, pp. 50.

Fowler, J. F., Jr. American Investment Trusts, New York and London, 1928, p. 415.

Grayson, T. J., Investment Trusts, Their Origin, Development and Operation, New York, 1928, pp. 420.

Robinson, L. R., British Investment Trusts, Trade Information Bulletin No. 88, United States Department of Commerce, April 16, 1923, pp. 34.

——, Foreign Credit Facilities in the United Kingdom. Columbia University Studies, 1923. Part 3, Chapters 8–14.

——, Investment Trust Organization and Management, New York, 1926, pp. 428.

Speaker, L. M. The Investment Trust, Chicago and New York, 1924, pp. 106.

Stanford University, Survey of American Investment Trust Organization and Management, 1928, pp. 5.

Tying, F. E. Jr., Investment Trusts, Modern Business Report No. 4. Alexander Hamilton Institute, 1923, pp. 29.

Williams, M. H., Investment Trusts in America, New York, 1928, pp. 152.

GENERAL BOOKS ON BANKING, FINANCE AND INVESTMENT
(Often contain one Chapter)

Kilborne, R. D., Principles of Money and Banking, Chicago and New York, 1927. Chapter XXXI, Investment Trusts, pp. 493–507 (Part contained in American Investment Trusts, Harvard Business Review, January, 1925, pp. 160–170.).

Moulton, H. G. Financial Organization of Society, Second edition, Chicago, 1925, Chapter XIV. The Marketing of Foreign Securities, pp. 245–260.

Badger, R. E. Investment Principles and Practices, New York,

1928. Chapter XXI. Financial Institutions—Investment Trusts pp. 540–559.
Edwards, G. W. Investing in Foreign Securities, New York, 1926. Chapter IV. Institutions for Foreign Investment, pp. 70–99.
Sturgis, H. S. Investment—A new Profession, New York, 1924, The Investment Trust, pp. 167–172.
Robinson, L. R. Investment Trusts, in Financial Handbook, second edition, New York, 1927, pp. 1595–1622.

ARTICLES AND PAMPHLETS

Albig, W. E. Investment Trusts, An Address before the Regional Savings Conference, Seattle, Washington, 1928.
Franklin, G. S. Investment Trusts, A paper read at a meeting of the New York State Bar Association, January 21, 1928.
Frederick, Leopold. Investment Trusts, Bankers Magazine, January, 1919, Volume 98, pp. 733–740.
Griffith, Sanford. Wall Street Journal, December 19, 21, 23, 29, 1924; January 4, 1925.
Grover, Lawrence. Annalist, September 2, 9, 16, 23, October 1, 21, 1927.
Higgins, E. Investment Trusts, Bankers Monthly, June, 1927.
Robinson, L. R. The Investment Trust and Today's Problems. An Address before the Conference on Foreign Investments, conducted by New York University in coöperation with the Investment Bankers Association, October 7, 1926, pp. 14.
Rukeyser, M. S. Forbes, September 15, October 15, December 1, 1927.
Thiesing, T. H. The Investment Trust as a Channel for Investment Abroad. Federal Reserve Bulletin, November, 1920, Volume 6, pp. 1168–1173; January, 1921, Volume 7, pp. 62–66.
Burton, C. S. (in collaboration with V. Dushayne) The Investment Trust, A Resumé, Its Adoption in the United States, Standard International Securities Corporation, 1928, pp. 57.
Guardian Trust Co. (Detroit) The Investment Trust, June, 1927, pp. 7.
Haney, L. H. The Investment Trust. What it is and What it does, United States Shares Corporation, 1928, pp. 27.
Hansl, Proctor W. Investment Trusts and Their Operation, With Particular Reference to the Mutual Investment Trust. C. Lester Horn and Company, Inc., 1928, pp. 30.
Morrison, P. L. The Investment Trust. A Financial Institution which can Render a Valuable Service to the Average Investor. Geo. M. Forman & Company, 1928, pp. 10.

Palmer, A. R. Investment Trusts. The Greatest Economic Discovery Since Man Evolved Corporations, second edition, Allan R. Palmer Company, Inc., 1927, pp. 26.

Questions and Answers about Investment Trusts in General and Standard International Securities Corporation in Particular, 1928, pp. 23.

The Investment Trust. What it is—the advantages which it offers to both small and large investors. P. H. Whiting and Company, Inc., 1927, pp. 14.

The Investment Trust Idea. What Others Say About It. Investment Trust of New York, Inc., 1928.

Twombly, E. B. Investment Trusts. An Address before the Connecticut Bankers Association, February 6, 1928, pp. 6.

CURRENT NEWSPAPERS AND PERIODICALS

British

Financial Times	(daily)
Economist	(weekly)
Statist	(")
Stock Exchange Gazette	(")

American

New York Times	(daily)
Journal of Commerce	(")
Wall Street Journal	(")
Commercial and Financial Chronicle	(weekly)
Barron's	(")
Bankers Magazine	(monthly)

Departments in { Commerce and Finance
The International Investor

Weekly pages in { Journal of Commerce
Wall Street Journal

BIBLIOGRAPHIES

Fowler, Appendix G, pp. 386–390.

Keane, C. P. Bibliography of Investment Trust Literature up to April 1, 1928. In Keane's Manual of Investment Trusts. (Contains books, articles, addresses and documents; based upon R. L. Smitley and E. Higgins), pp. 818–829.

Smith, J. G. The Development of Trust Companies in the United States, New York, 1928. Investment of Trust Funds and Investment Trusts, pp. 533–537. (Largely articles on former.)

COLLECTIONS OF INVESTMENT TRUST DATA

British Trusts.

The Stock Exchange Official Intelligence.

The Stock Exchange Year Book.

Moody, Manual of Investments. Banks & Finance, 1928, pp. 2417–2458.

Statistical compilations and comment annually for leading British and Scottish trusts, in (London) Financial Times.

American Trusts.

Moody, Manual of Investments, Banks and Finance, 1928, pp. 1995–2038, 2686–2718.

Keane, C. P. Keane's Manual of Investment Trusts. 1928, p. 886 (Contains statements of trusts, selected articles and documents, bibliography, and directory of directors, etc.).

United States Investor, Investment Trust Edition—1928, April 28, 1928, p. 90. (Contains several articles and statements.)

Standard Statistics Company. Standard Trade and Securities Service, March 23, 1927, and August 27, 1927 (tabulations furnished by E. Higgins; classified lists and brief data).

Attorney General of the State of New York, Survey, pp. 124–132. (Contains classified lists)

Fowler, Appendix A, Classified Directory of American Investment Trusts, pp. 251–259.

SELECTED REFERENCES FOR CHAPTER I

Fowler, Ch. XVIII, Place of Investment Trusts in American Finance, pp 240–250.

Grayson, Chapter I, Introduction, pp. 1–10.

Robinson, Chapter I, Purpose and Characteristics of the Investment Trust, pp. 3–17; pp. 59–62.

Speaker, Chapter IV, Economic Services of the Investment Trust, pp. 61–68.

Williams, Chapter I, Crystallizing the Law of Averages, pp. 1–7; Appendix B, Specific Trust Conceptions, pp. 133–152.

Jörgens, M. Finanzielle Trustgesellschaften, Stuttgart u. Berlin, 1902, pp. 1–10; 155–160.

Liefmann, R. Beteiligungs und Finanzierungsgesellschaften, Zweite Auflage, Jena, 1912, pp. 71–81; 193–201; 598–613.

Chapman, J. M. The Investment Trust in International Finance. Joint Security Corporation, 1928, pp. 16.

Robinson, L. R. Why Investment Trusts? United States Investor, April 28, 1928, reprinted in Keane, pp. 550–551.

CHAPTER II

RISE OF THE INVESTMENT TRUST IN ENGLAND AND SCOTLAND

In 1822 was formed at Brussels what seems to have been the first organization of an investment trust nature, and similar companies were organized during the following decade.[1] Somewhat later, Swiss private bankers, who wished to keep investment separate from commercial banking, organized companies to handle their investment properties as separate entities. Growth upon the continent was, however, slow during the first half of the 19th century, due in part to the fact that European investment banking fundamentally covered in great degree the field now occupied by the investment trust, and that, as already noted, investment intermediaries later developed assumed a somewhat different form.

Hence the investment trust, as we understand it today, is practically of British origin, and until the recent American movement, has had its principal development there. Today the English and Scottish trusts are pillars of financial strength. Their early start in the British Isles from small beginnings has given them a considerable history. The experimentation they undertook in order to surmount the obstacles and difficulties they encountered and to develop a more or less standardized practice on various phases, is

[1] Jones, G. M. The Origin of Investment Trusts, Commerce Reports, Sept. 1, 1924, p. 535. For a sketch of historical development in continental countries, see Thiesing, T. H., The Investment Trust as a Channel for Investment Abroad, Federal Reserve Bulletin, Jan., 1921, Vol. 7, pp. 62–66.

extremely enlightening. The history, too, has included varied periods—some placid, some stormy. The manner in which these trusts faced and solved the problems which presented themselves as well as the mistakes they made shed much light for the American student of investment trusts.

THE PRE-INVESTMENT TRUST ERA

The early years of the 19th century found British investments narrowly restricted. Funds were placed either in securities representing the national debt, or in obligations secured by real estate. Industrial and transportation securities were rare, and were regarded as highly speculative. Not only was the range of securities narrow, but investors were relatively few in number. They represented wealthy landed and professional groups, whose holdings were in large units. They generally favored consols (British government obligations), which then yielded around 5%.

From time to time, conservative finance gave way to waves of speculation. After the great destruction wrought by the Napoleonic wars, which caused England to become the leading creditor nation, the world entered upon a period of recovery. Investors had much money. On the other hand, states and municipalities needed funds badly, and numerous adventurous souls appeared to help these investors use their money. Conversion of the national debt afforded a strong and direct stimulus to speculation. In 1822 the English government refunded the "Navy Five Per Cents" into an issue bearing 4%, and followed this operation by others of a similar nature. Investors found their income radically reduced, and began to seek out newer opportunities of a more remunerative sort. By 1825 an orgy of speculation had developed. To quote one writer:[2]

> By the beginning of 1825 the public was as mad as in the Bubble days. The Times and Morning Chronicle of January 23 and 24, 1825, contained the prespectuses of 35 new companies. By the end of 1825 there had been promoted 624 companies, with a capitalization of 372,173,100 pounds. Whether or not warming pans and skates were actually exported to the tropics, it is certain that Scotch dairy-women emigrated to Buenos Aires for the purpose of milking wild cows and churning butter for people who preferred oil.

In 1835 the panic put an end to this mushroom growth, especially in respect to numerous foreign bonds which had been offered at attractive rates. During the following decade public interest in railroad securities increased. The middle class supported the great speculative railway boom of 1845, which had so much to do with causing the panic of 1847, and they again lost heavily. Thus the efforts of the British middle class to obtain higher rates of return had twice resulted in disastrous loss as a result of the speculative risks they undertook. They saw that larger investors had been able better to protect their holdings through careful analysis and critical supervision obtained in large part from solicitors and other agents in the leading centers, since the leisure class itself possessed but little business knowledge. The realization of their advantages in obtaining the requisite information and skill paved the way for the idea of investment by proxy as a substitute for speculation. This would further enable diversification and hence

[2] Powell, E. T. The Evolution of the Money Market, 1385–1915, London, 1915, pp. 325–326.

reduction of the risk, while it would, in effect, also set aside part of the excess return as a reserve against risk.

FORMATIVE PERIOD OF THE INVESTMENT TRUST (1863–1887)

The result of this realization was the appearance of the investment trust. This body would shift the duty of supervising the investments from the individual solicitor or other agent to itself, a not unwelcome change to that individual, especially since it provided coöperation in pooling and diversification.[3] In 1863 two trusts in the present sense of the term made their appearance—the London Financial Association and the International Financial Society. With funds realized from the sale of their own shares they made loans chiefly to railroads which, in turn, deposited their securities as collateral. Many of these securities, however, proved illiquid, and the holdings were not diversified. Hence the experience was by no means satisfactory.

The Foreign and Colonial Government Trust, formed in 1868, and still in existence, applied sounder principles. It had a capital of 1,000,000 pounds, composed of shares of 100 pounds each, which were sold (fully paid) at 85 and carried a 6% dividend rate, that is, a 7% yield on purchase price. Five trustees were to provide broad geographic diversification by purchasing 18 security issues of foreign countries. The average yield on these was 8%, and the extra 1% or so above dividend requirements and expense was to be used as a reserve against loss and a sinking fund to draw capital annually. If no loss occurred, all the capital would be drawn in 24 years. Thus they were to pro-

[3] An oft-repeated story is that of the Scot who, visiting the United States in the early sixties, was asked to pick up some choice investments for a number of his friends and was thereby led to undertake the formation of the first trust. Higgins, Investment Trusts, Bankers Monthly, June, 1927.

vide securities to fit the needs of the middle class investor.

Subsequent trusts were constructed along similar lines. Certificates, however, were often of nominal amount, and bore a fixed rate of 5 to 6%, payable semi-annually. If unearned, this was paid at times from the capital fund. Earnings from interest received and appreciation of securities, remaining after paying cost of administration and interest on certificates, were used to call certificates yearly. The trust usually ran for from 20 to 30 years, when the fund was to be distributed in accordance with the deed of trust. It named a fixed minimum and maximum amount of capital and when the latter was reached a second trust might be formed. The trust usually limited the amount of securities to be purchased, as well as the amount to be placed in one security, which it set at 5 to 10% of capital. It provided that the securities be held either by the trustees or by a bank, and required periodical disclosures of the portfolio.

As time went on, modifications of the earlier principles appeared. First, investments were broadened, perhaps reflecting the changes in the British capital market as continental centers began to compete actively with London. Private securities, both rail and utility, were purchased as well as governments; preferred, and even common stocks, as well as bonds. Land mortgages were also extensively used, and some trusts held most of their funds in that form. The principles of distribution of risk and close supervision of the portfolio became increasingly recognized.

Trust structure, too, was modified. Two classes of certificates were created instead of one. One was preferred as to assets and dividends, the other was deferred. Thus, instead of having all equal participants in the enterprise, part of the investors alone conducted the business. Some trusts wished to carry further this idea of "trading on the equity,'' as it is called in financial discussions, and borrowed to supplement their share capital, but some trustees did not wish to assume the responsibility otherwise inherent in the exercise of their discretion. Accordingly a number of trusts—formed at first before the corporation laws had been fully crystallized into the Companies Acts, and hence unincorporated, voluntary and fiduciary—took the corporate form, issuing debentures which usually were limited to the amount of the share capital. In the late seventies, too, the legality of the unregistered common law trust was attacked. Opponents claimed that under English law every profit-seeking enterprise of over twenty members must be incorporated under the Companies Act of 1862. Finally, after an unfavorable decision was rendered in 1879, the legality of the original trust device was upheld, but in the meantime all the trusts save one had converted themselves into limited liability companies under the Companies Act.

A third modification evident was that the trusts, especially during the eighties, began to develop a number of other lines of activity. The demand for corporate trustees led some to take on such business and to act as trustees or executors—work which involved chiefly the administration of security holdings. Others operated places of safe deposit, granted fidelity policies, or guaranteed the payment of obligations. But far more important was a tendency to invade the field properly belonging to finance and credit companies and to obscure the distinction between them and investment trusts proper. Many trusts began to interest themselves in promotion and syndicate operations, and either negotiated loans or issued shares on commission. But this was to a much greater extent a feature of the subsequent boom period; during the earlier part they kept largely to their program.

The growth of the trusts during this period, however, was very gradual. Despite the impetus given by the further reduction of the rate on consols in 1880 to the redistribution of English security holdings, and the opening of a new era in the United States and South America, in 1886 only twelve trusts were listed on the London Stock Exchange, few of which were organized before 1879. The accompanying table from the Economist of July 10, 1886 [4] sheds much light upon them.

Capital structure of trusts listed on the London Stock Exchange in 1886

Name	Date of Formation	Preferred	Capital Ordinary (common)	Loan
1 Foreign & Colonial Government Trust	1868	£1,202,000	£1,107,000	
Governments Stock Investment	1871		500,000	179,000
x Sumbarine Cable Trust	1871		339,000	
x Globe Telegraph & Trust	1873	1,770,000	1,772,000	
2 Railway Debenture Trust	1873		500,000	1,316,000
2 Railway Share Trust	1873	471,000	500,000	
1 American Investment Trust	1879	500,000	500,000	
Municipal Trust	1879		214,000	
z Omnium Securities	1879	93,000	20,000	29,000
w Railway Investment	1881	1,700,000	1,700,000	
1 Foreign American and General Investment Trust	1883	750,000	750,000	333,000
Mercantile Investment & General Trust	1884	175,000	175,000	
		6,661,000	8,077,000	1,857,000

[4] P. 857.

1—To all intents and purposes under same managment
2—To all intents and purposes under same managment
x—Practically trust for telegraph shares
z—Almost exclusively a land mortgage corporation.
w—Restricted to common shares of four English Home Railways, hence a "fixed" trust. This trust applied three times before it was listed.

Note: Five of the companies had been trusts in form, but the others began as companies. Only one (number three) remained a trust.
The second, fifth, sixth, seventh, eleventh and twelfth were managed with skill and foresight, and profits were not dissipated in dividends.

Other companies were in existence at this time, but the London Economist considered them relatively insignificant. That publication notes that the listed trusts turned over their security holdings quite frequently during the course of the year. They paid 6% on their deferred or common stock, which was selling to yield around 5%, while their preferred stock carried a yield of about 1% less. Attention may be directed towards the group management shown in the table, as well as the investment specialization indicated.

BOOM CONDITIONS (1888–1890)

The close of the eighties witnessed a period of feverish speculation. Many new trusts were organized, as well as companies of other kinds. The United States after the resumption of specie payments and the appearance of rapid expansion, proved attractive, as did the Argentine. From railroad securities and loans on land, attention turned to more speculative undertakings, and mines and plantations were favored instead. The gold and diamond fields of South Africa drew much capital. Bank stocks were not included, however, because the banks refused to accept trusts as shareholders.

The process of foreign investment (via the investment trust) drew further stimulus from the refunding of the consols in 1889, after an earlier reduction in the interest rate on them had been made in 1880. Furthermore, while interest rates were falling, the British were accumulating funds so rapidly that opportunities for investment at home did not suffice. The new trusts provided opportunities for participation in high rate foreign investments,—not without risk, yet not purely speculative in character since much data was available concerning them—and the public enthusiastically welcomed investment trust securities.

The increase in the number of trusts is shown by the following data. In July, 1888, 36 trusts were listed on the exchange, or three times the number listed in 1886, and they were placed in a separate section of the London official list. While 15 of the companies formed in 1888 were capitalized at 9,500,000 pounds, 19 of the more important companies formed in 1889 had a combined capitalization of over 25,000,000 pounds. In 1888 over 70 undertakings were registered, with an authorized capital exceeding 70,000,000 pounds, but many of these never passed the stage of registration. Old trusts formed new ones. During the first three months of 1889 the public was offered 17,000,000 pounds of investment trust securities. Issues in 1890 were somewhat smaller than in 1889, while in 1891 they were only about as large as in 1888, and then fell off greatly. The issues of 1891 and 1892 were only to get fluid capital, or else to reconstruct an old company.

The very rapidity with which trusts were formed soon intensified otherwise difficult investment problems. Some trusts had almost identical directorates and security holdings, and such group management became an element of weakness rather than of strength. The bull market following the depression of the mid-eighties had already pushed security prices to high levels. Securities that were both good and cheap became scarce. Competition among the trusts for the limited supply of sound securities available only served further to increase prices and took out of the general market the best shares of good corporations. Thus some trusts experienced great difficulty in laying out their initial funds, and as a group they forced themselves either into other fields of activity or into purchases of unlisted securities with higher yield but greater risk, in order to meet the expectations of purchasers of their own securities.

The period as a whole therefore became one of wild speculation. Speculative glamour gave an incentive to trust formation; while, on the other hand, increased trust formation resulted in further pressure to increase speculative operations. The trusts neglected to diversify, but instead specifically emphasized specialization. In October, 1889, nearly one-third the investments of eight principal London trusts were in securities of South American States. Special skill of directors in certain fields could not avail against such practices. Again, they looked especially to turnover of portfolio in order to profit from the price increase. This was stimulated by the formation of new trusts, and fell off as the latter ceased to come forward. A number turned largely to underwriting [5] and promotion work, and made this their leading activity; in other words, they became financial rather than investment trusts.[6] So long as mar-

[5] Underwriting as we know it today had not yet evolved, and trusts were often used as adjuncts of houses issuing foreign securities, being designed as a resting place for that portion of a new issue which remained unsold.

[6] In August, 1890 eleven large trusts had developed 71 other entities.

kets boomed, they fared well; but all too soon they found themselves with masses of unsalable securities on their hands. Contemporary critics early noted the instability of underwriting income, but the trusts did not take heed. These critics called attention to the frequent concealment of the list of securities from shareholders, terming the trusts "blind pools," and noted the liabilities the shareholders were under because of the other activities conducted.

Venturesome practices were stimulated by the use of founders shares. The management of a new company received a few hundred such shares, which were fully paid at a low figure. They shared in earnings after a specified non-cumulative rate had been paid on the common, in some cases in one-half the excess earnings. Thus, the interest of managers and investors was directly opposed. The managers had but a small investment, and it was to their direct advantage to withhold dividends on the common shares as well as to speculate. In the brief period of four years, one British trust paid the founders 160,000 pounds on an original investment of 300 pounds. This practice naturally also weakened the ability of the trust to weather adversity, as did the practice of paying dividends out of unrealized market appreciation (and thereby decreasing the equity behind debentures and preferred shares) in order to encourage investment in trust securities.

Similar weakening occurred through the issue of common shares which were only partly paid. The theory underlying this practice—used by the English joint stock banks—is that it creates for the protection of creditors a reserve liability equal to several times the paid in capital. The stockholders were in a very bad situation after the financial troubles of the early nineties. The Economist stated in 1892 that the very trust that had paid its founders 160,000 pounds on their 300 pound investment was now in such difficulty that holders of the common shares (of a par value of 10 pounds, of which 3 pounds was paid up and 7 pounds remained subject to call), were offering 2 pounds each to a purchaser so as to remove their call liability.

During this period there went forward also the plan of stock splitting already found in the Railway Investment Trust of 1881. Registered in 1888 under another name, the Stock Conversion and Investment Trust Ltd. in 1889 issued preferred stock for sale to investors and deferred for sale to speculators, against a block of high priced stock of an English railway. The theory was that the value of split stocks exceeded that of the deposited collateral, but the railways opposed the plan.

STORM AND STRESS (1891–1894)

During 1889 and the early part of 1890 the Economist and the Statist repeatedly warned of the unhealthy conditions prevailing. A revolution broke out in the Argentine in July, 1890, and immediately the market for South American securities collapsed. Many of these securities were held in investment trust portfolios. On November 16, 1890 the great financial house of Baring failed, and a financial panic ensued in every important money market. Securities bought at high prices were deflated, and many of them were found worthless.

Thus the period from 1891 to 1894 was exceedingly painful in investment trust history. Having sown the wind, they reaped the whirlwind. Gains on security resale ceased; and, worse yet, the trusts found themselves overloaded with frozen securities bought at excessive prices. The complete effects of the drop in security prices were only disclosed in succeeding years, especially in 1893, when the panic in the United States adversely affected many securities held in British trust portfolios. Many of the smaller and weaker companies that engaged in promotion, financing and other extraneous activities passed out of existence. The stronger and better companies weathered the storm, but in some of them the common stock equity was entirely wiped out by the depreciation in their security holdings. Several passed to new management, while in others a substantial part, if not all, of the common stock equity was written down when the securities were revalued. Stock in several trusts was either given away freely to those who would assume liability for further calls, or even sold for negative values. Because of the relatively small amount of bonding, however, no actual failures occurred among the leading trusts. The contrast between the best and the poorest trusts is perhaps most graphically shown by the fact that at the lowest point of trust security prices in 1893, seven out of thirty-one representative trusts had the value of their securities in excess of the original issue price, although others showed great declines, in the aggregate about one-third.

The trouble which the trusts experienced in preparing their balance sheets for the year 1890 illustrates their problem. The trusts had previously recorded and distributed capital gains, whether realized or not, and often did not distinguish them in their accounts. Should they therefore pass dividends while security depreciation continued? Finally, a court decision in the so-called Verner case permitted investment trusts to carry securities at cost, but required them to write off a continuing loss in value. Financing companies, however, which dealt in securities, were to use market price. Thus trusts could continue to pay dividends from current income unless extreme depreciation existed. Despite some drastic readjustments mentioned, no major company passed its preferred dividend in 1892, although several lowered their rates. The dividend rates on the ordinary stocks were almost universally reduced, and in about half a dozen cases were eliminated in that year. The dividend record of some trusts, as well as the security prices on two selected dates, are given in the accompanying table on pp. 32–33.[7]

As a result of their difficulties, the name "trust" became a byword of reproach. Trust securities became as unpopular as they formerly had been favored. A practice not calculated to add to their repute was followed immediately after the Baring crisis in 1890. The management of a few trusts found that they, as individuals, or the trusts which they operated, owned many securities which had depreciated greatly, and which in some cases were almost unmarketable. To avoid loss, they created new "relief" trusts under the same management, and dumped the undesirable securities on the new organizations at a price in excess of the then low market value. The public had not yet become suspicious of trust securities, and took up the new trust's issues. In some cases, at least, the managers could do little other than let a trust so handicapped at the outset fail. The same practice was followed by many investment houses and private bankers.

STEADY GROWTH (1895–1919)

The trusts took the lessons of the early nineties to heart. The few which had adhered strictly to the early conserva-

[7] Jörgens, pp. 42–43. See also, for original quotations and those in September, 1893 for 31 representative trusts, the table in the Economist, September 9, 1893, p. 1083.

tive canons had fared well; and those which departed therefrom in general suffered in proportion as they abandoned the earlier practices. Hence there was a steady reversion to the pure investment trust type, and the investment trust was distinguished sharply from the financial trust. In future each trod its separate path. In order to regain the confidence of the investing public many trusts inaugurated the policy of publishing investment lists periodically, which they had gradually abandoned during more prosperous days. The trusts were able to live down their evil reputation, and from the second half of 1894 on, their securities began once more to rise in price.

The chief factor in the rehabilitation of the trusts, however, was probably the change in underlying economic conditions which took place. The late nineties afforded great investment opportunities. Security prices were low as a result of the depression. On the other hand, money could be borrowed as cheaply as 3%. Some of the most successful trusts of today are those which during this period obtained control of vast amounts of capital on very favorable terms through the sale of perpetual debentures or preference stock. Throughout the period, the trust was a strong aid to British foreign investment, which proved the handmaid of British foreign trade.

Nevertheless, few trusts were formed between 1895 and 1907 as compared with the activity of the later eighties, but more development appeared after 1907. Perhaps this inactivity was due, as Liefmann claims,[8] to the greater range and scope of stabilized investment opportunities, which led the investor to participate directly in business enterprises himself, instead of indirectly through purchase of investment trust securities. In any event, the growth was slow, steady and sound. Despite the severe

[8] P. 194.

DIVIDEND RECORD AND SECURITY OF PRICES OF TRUSTS CREATED BEFORE 1887 & QUOTED ON LONDON STOCK EXCHANGE

Name		Dividends 1887–1898	Market 6/28/90	Market 12/30/93
Gov. Stocks & Other Secs. Inv. Tr. formerly Gov. St. I. T.	4½ p.	Paid throughout	105–8	70–4
	def.	6, 7½, 7½, 7½, —, —, 1, —, 1, 1, 1, 1	112–5	28–32
Submarine Cable Trust	6% ct.	Paid throughout	112–6	114–9
Globe Tel. & Tr. Co.	6% pf.	Paid throughout	—	—
	def.	2⅜, 3½, 4⅝, 5, 5¼, 4⅞, 4⅝, 4½, 4⅛, 4½, 4½, 5⅛	—	—
Ry. Def. & Genl. Tr. Co. formerly Ry. Deb. Tr. Co.	con.	7, 7, 6, 7, 6, 6, 6, 4, 4, 4, 4, 4½	110–20	55–65
Ry. Share Tr. Co.	6(71/2)% pf.	6 for 1887–93 7 1/2 for 1894–8	126–8	104–7
	def.	4, 4, 4, 5, 4, 4, 4, 3, 4, 4, 4, 5	82½–87½	40–5
Amer. Inv. Tr. Co.	5% p.	Paid throughout	114–7	117–22
	con.	6, 6½, 6½, 7, 7, 8, 8, 6½, 6½, 5½, 5½, 5	120–3	113–8
For. & Col. Gov. Trust Company	5% p.	Paid throughout	125–8	119–23
	def.	7, 7, 8, 8, 8, 6, 5½, 5½, 5½, 5, 4½, 5	140–4	93–8

Municipal Tr. Co.	5% pf.	Paid throughout	100–3	90–5
	def.	4, 5, 6, 8, 7, 6, 5, 2, —, —, —, —	112–6	77–8
Ominum Inv. Co. formerly Ominum Secs. Co.	4½ (5) p.	4½ 1887–94; 5 1895–8	99–101	54–9
	def.	7, 7, 7½, 7½, 2½, 1, —, —, —, 1, 1, 1	—	—
Ry. Inv. Co.	4% p.	Paid except 3½ in 1894	101–3	96–8
	def.	1/8, 1/5, ½, 1, 1, 1, ¼, —, 1/8, ¼, 1, 1	26½–27½	13½–14½
For. Amer. & Genl. Inv. Tr. Co.	5% p.	Paid throughout	114–7	100–3
	def.	6, 6, 7, 7, 7, 5, 5, 3, 3, 23/4, 3, 3	116–20	55–60
Merc. Inv. & Genl. Tr. Co.	5% p.	Paid throughout	115–8	82–7
	def.	6½ 7, 7, 7, 7, 5, 5, 3, 2¾, 2½, 2½, 2½	116–9	32–7
U. S. & S. Amer. I. T. Co.	5% p.	Paid throughout	104–7	72–7
	def.	5, 7, 6, 6, 5, 3½, 2½, 2, 2, 2, 1½, 1	102–5	35–40

security depression in 1907, no casualties were recorded. During the World War, too, when new trusts were rare, the trusts weathered the storm well. Earnings dropped moderately in 1914 and 1915 but not to the 1909 level. They suffered severe depreciation in the capital value of their holdings; but capital depreciation did not seriously affect their dividend capacity. The latter was, however, affected to some extent by the reduced income from investments, industrial and other, whose earning power was at least temporarily disturbed by the war. They were forced to dispose of their American holdings as an incident in war finance to help the British Government obtain credits in the United States. These realisations were made at large profits on the original purchase prices and the money was reinvested in British Government and other securities giving good interest yields owing to the huge borrowing for war purposes. Hence the depreciation in value of some investments was in part offset by actual realisation of profit on other investments and by remunerative reinvestment of that money. Deranged foreign exchanges afforded many opportunities for profit, but more chance for loss as well. Nevertheless, no drastic reduction of earnings took place, and dividends were not affected materially. Similarly, investment depreciation was covered in considerable measure by reserves as well as by the rise in security prices in 1919. Of twenty-two leading trusts, in May, 1920, the London Times reported that eight were fully covered, four showed a slightly greater depreciation, and nine were uncovered, while one was not stated.[9]

POST-WAR DEVELOPMENT (1920–)

The English trusts had learned their lesson in the nineties, and the depression of 1921 left them largely un-

[9] See table in Speaker, p. 21.

scathed. The war and the crisis left security prices low, and once again excellent investment opportunities appeared. The subsequent worldwide rising tide of security prices has afforded perhaps unparalleled opportunity for capital gains, a part of which, however, serves merely to offset such war time depreciation in investments held as was not offset by sale at high prices of the remaining American securities held in trust portfolios. Net earnings, too, have increased steadily and rapidly since 1922. At the same time, the war loans had created a host of new and small investors who needed guidance in laying out their funds. Especially was this needed at a time when old landmarks of security prices and yields, as well as economic conditions in the various investment fields, were disturbed if not entirely destroyed. The investment trust had meanwhile attracted attention in the United States as a result of its new position as a creditor nation. The stocks of investment trusts have been in great public demand, and those of the older trusts are very scarce in the market.

Trust formation and expansion, largely dormant during the war and early post war periods, began with renewed vigor.[10] Year after year more new trusts appealed to the public for funds, especially beginning with 1924, while existing trusts increased their capital in a number of cases.[11] Old trust groups have formed new trusts to add to their

10 The Attorney General of the State of New York (Survey, p. 6) summarizes British trust formation as follows: "Of the total number of British investment trusts, some 50 or 60 were organized between 1863 and 1890, eight or ten from 1890 to 1900, twenty-five to thirty between 1900 and the outbreak of the war, and approximately forty since the war." A list of British trusts, with dates of formation, is given in Robinson, Appendix B, pp. 358–360.

11 The Attorney General of the State of New York (Survey, pp. 6–7) estimates that at the close of 1927 there were 125 or more investment trusts, with total paid-in capital assets in excess of £150,000,000, and 150 or more financing companies and financial trusts, whose total paid-in capital assets exceeded £200,000,000.

families, for which much of the capital has been subscribed by the stockholders of the earlier trusts or by members of the managing group, and some further concentration among the groups is anticipated, whether through further extension of interlocking directorates or otherwise. But many specialized trusts have also been formed, by men not heretofore identified with investment trusts but familiar with a given industry such as rubber or tin, to hold securities in that special field. They are subject to wider market fluctuations, but in certain cases have made very big money. Many of these companies partake of the nature of financial rather than investment trusts, and some of the older trust executives are dubious as to their ultimate success. The rubber slump of 1928 is evidence of the unwisdom of specialized trusts, which are the negation of the trust idea of spreading risks.

Trust investment policy as a whole has become more speculative, and trusts are handling many entirely new flotations instead of confining their purchases solely to tested investment securities. However, the American discussion of the virtues of common stocks as contrasted with bonds, and of the desirability of timing investments and turning them over to accord with changes in general economic conditions has met with relatively little acceptance. Only in the case of a few trusts recently formed in conjunction with some London stock brokers does this seem to play an important rôle; in traditional British practice careful selection of individual securities is paramount. And this development of stock brokers trusts is likewise new; for the traditional British ideal has been the maintenance of an independent investment position, though dominated by capitalists with important financial contacts. Finally, several coöperative trusts have been formed under the friendly societies rather than the companies acts. They are designed to appeal to small individuals who participate for limited amounts only, and the holders of their shares are exempt from the British income tax.

Shifts have taken place in trust portfolios during and after the war. Most noticeable has been a relative reduction in the holdings of American securities. During the war this had been due to the necessities of governmental finance, but after the war it was due to the foreign exchange uncertainties, with the high fluctuating premium on the dollar, and to the anticipated rise in sterling exchange, as well as in part to the American income tax. The subsequent reëstablishment of sterling at its pre-war parity has tended to reverse this movement. At the same time, considerable increase in investments in Latin America was evident up to about 1925. The funds withdrawn from American securities were further used to buy British government issues during the war, which have subsequently been liquidated to some extent, and also other domestic issues. During this period, finally, an increase in the proportion of bonds and preference shares held in trust portfolios was evident. Illustrative of the sound condition of trust portfolios is the fact that the London Financial Times showed the nominal value of the common shares of thirty-one British investment trust at the opening of 1924 to be 18,202,000 pounds and their market value on the London exchange to be 25,000,000 pounds, as contrasted with 31,709,000 pounds at the end of January, 1925, every one already being at a premium then, despite the fact that early in 1919, twenty-two of the thirty-one stocks were quoted at a discount.

A last development worth noting has been the revival of borrowing by the trusts. As in the late nineties, lower interest rates and public preference for non-speculative securities have led to this. The funds so acquired could, furthermore, be profitably employed in picking up securities depreciated in value as a result of business depression rather than inherent weakness. The chief cause of the higher percentage of proprietary capital since the nineties was due to the fact that earlier trusts had reached the limit of their borrowing capacity, and to the growth of financing, trading and promoting companies.

SELECTED REFERENCES

Grayson, Chapter II, Historical Development, pp. 11–21. Chapter III Laws Governing British Investment Trusts, pp. 22–32.

Robinson, Chapter XI. Tendencies in British Investment Trust Development, pp. 187–206.

Speaker, Chapter I. Introductory, Nature and Historical Development of the Investment Trust, pp. 3–22.

Jörgens, M. Chapter I. Die Investment Trusts. Entstehung, Organisation und Entwicklung, 1868–1886, pp. 13–25. Chapter II Die Entwicklung der Investment Trusts seit 1887. Die Entstehung der Financial Trusts, pp. 26–52.

Liefmann, R. Pages 133–157.

Powell, E. T. The Evolution of the Money Market, 1385–1915. London, 1915. Chapter XVI. The Financial Trusts—"Investment by Proxy" and Its Extension, pp. 464–478.

Jones, G. M. The Origin of Investment Trusts, Commerce Reports, Sept. 1, 1924, p. 535.

McFadden, Hon. L. T. Investment Trusts. Their Benefits and Dangers as Shown by British Experience of 1882. Speech in the House of Representatives, Wed., Feb. 29, 1928. Exhibit E, quotations from The Economist, 1882–1925, pp. 21–38.

Smith, E. L. British Investment Trusts—A Warning. Atlantic Monthly, Oct., 1927.

Current British periodicals listed in Bibliographical Note, especially the Economist.

CHAPTER III

AMERICAN INVESTMENT TRUST DEVELOPMENT

The earlier investment banking mechanism in the United States differed radically from that prevailing in England. But the basic idea of the investment trust is not new in this country; for a century some institutions have existed here that are more or less similar to it. Only today have they culminated—ultimately—in the formal investment trust. In the United States the investment trust is practically a post-war growth and results from the economic situation sketched in the opening chapter. It is exotic in the same sense as is the Federal reserve banking system, which represents adaptation of European practice to American need. Hence American investment trusts show certain modifications of British practice, both as to structure and method of operation. Their extremely rapid growth has naturally led to much diversity of practice. Today they in the aggregate are probably as large as the British trusts, although they do not exercise anything like the degree of independent influence in the market that the British trusts do. To set the present American situation in its historical background, sheds much light upon the investment trust and enables a clearer appraisal of it.

FORERUNNERS OF THE INVESTMENT TRUST

If one looks back a century, he finds certain organizations more or less similar in various ways to the investment trust, each with one or more of the latter's characteristics, but none with all. Perhaps most parallel is one of the early trust companies, and not far behind in some ways is some of the personal trust work of others.[1] The Massachusetts Hospital Life Insurance Company in 1823 first accepted "annuities in trust" and "endowments in trust" which gave beneficiaries under certain conditions, not the income from their trust property (as in ordinary "living" trusts) but, since the trust property was not segregated, gave them instead their share of the income derived from all the funds of the company. The company was not only manager of the fund but trustee as well, hence Smith states that "as a matter of fact the early organization of the company is virtually that of an Investment Trust as that term is now used."[2] The amount of trust funds received grew rapidly, from approximately $69,000 at the end of 1823 to nearly $5,000,000 at the end of 1830. The company is even today regarded as peculiar; while it is listed with the trust companies, it is considered neither as trust company, insurance company, nor bank. A contemporary in the 1820's called it "eminently the Savings bank of the wealthy."[3]

The savings bank started some hundred years ago as mutual in structure. It had no capital stock, but was owned by its depositors and operated in their interest by a group of trustees. These trustees were influential men who received no compensation but gave freely of their time and knowledge for the benefit of their less fortunate brethren. The depositors were people of small means who, as the country became more industrialized, had no outlet for their funds through direct use in industry. Hence the investment of the savings bank's funds was closely restricted

[1] Smith, J. G., The Development of Trust Companies in the United States, New York, 1928, ch. XII, especially pp. 238–245.
[2] Ibid, p. 244.
[3] Ibid, p. 245.

by law, and safety instead of return was regarded as paramount. Its investments were confined to real estate first mortgages and high grade bonds of a few specified kinds. In short, these savings banks represented contributions to a common fund by depositors who were privileged to withdraw at will on a specified number of days' notice, the said fund to be invested for the common benefit by the trustees.

Hence, also, the mutual savings bank arose almost solely in the northeastern states, while in the west and south there were created either stock savings banks which paid a fixed rate of interest to their depositors and gave any profits remaining to the stockholders who owned the bank, or else savings departments in commercial banking institutions.

As time passed, the mutual savings bank lost some of its early characteristics. The maximum size of the deposit which one individual may have to his credit has steadily increased, until today it stands in a state like New York at $7,500. The range of investments permitted has also steadily increased, partly in response to new investment theories, partly due to practical necessities. More and more these institutions have had to compete with thrift and savings departments in other banks that are frankly run for profit. In these other institutions, the savings funds are generally not separated from the general assets, but are mingled, so that there is no separate investment problem, but merely one general investment problem for the bank as a whole.

Life insurance companies in many ways may be regarded as investment institutions. The early trust companies, in fact, combined insurance with trust business, but later recognized each as a separate branch, deriving no benefit from its conduct by an organization also carrying on the other activity. Life insurance companies have large funds in hand, since they must accumulate a sum sufficient on the average to pay each policy upon the insured's decease. Their investments, too, have been restricted, especially since the Hughes investigation of 1906 in New York, which caused them to be forbidden to participate in underwriting syndicates and after which they were mutualized. In general, life insurance company investments are similar to those permitted trust companies and savings banks and the insurance policy in fact may be considered a special type of savings plan for the insured. Other branches of insurance, however, continue to be conducted by stock companies. These have much greater freedom of investment, and their security operations often yield their sole revenue to their stockholders, the writing of insurance itself resulting in a loss.

Real estate loans have also offered a considerable outlet for savings. The building and loan association originally joined together small savers interested in homebuilding, and subsequently invited outsiders who did not desire to borrow themselves, to participate with their funds. Urban and farm mortgage bankers often joined together a variety of mortgage loans they had made, depositing them with a trustee, and sold participations or bonds against the group of loans to investors, instead of merely an interest in a single loan. This was extended and formalized for farm loans in the Federal Farm Loan system created in 1916, which provided for both Federal and joint stock land banks, as well as in the rural credit plans enacted by various states.

Finally, some railroads became more or less investment trusts. The Union Pacific affords the classic example. The Harriman policy of finance was to accumulate large amounts of funds for acquisition of other roads, but pending such use, to invest the funds in securities so as to earn their keep. The result has been that the road has permanently acquired large holdings of investment securities, other than those representing purely subsidiary activities, such as hotels, lumbering, etc. The Adams Express Company is another organization which has pursued a like course. Only in companies of this type, it may be observed, is much managerial discretion possible with respect to investment holdings, and can the newer investment theories be applied.

PRE-WAR INVESTMENT TRUSTS

All these organizations were similar in certain ways to the investment trust found in Great Britain, as was the holding company in the public utility and other fields, formed for purposes of control rather than investment. But during several decades before the war a number of scattered trusts arose, designed for the sole purpose of investing funds entrusted to them, yet not falling under any of the categories already mentioned and exhibiting rather diverse structure.

One of the oldest trusts—if not the oldest—today in existence in the United States is the Boston Personal Property Trust, organized as a Massachusetts trust in 1893. The five trustees have almost complete discretion in investing the fund, which is held by a trust company as depositary. They are self perpetuating, and receive an aggregate amount not to exceed 5% of the gross income, as well as 1% of the total fund when and if finally distributed. They make annual accountings and deliver the same upon request to each certificate holder, to whose inspection their books are always open. The capital, surplus capital (cash profits from sales of investments and premiums on subscriptions, as well as rights, stock dividends, etc.) and surplus income (excluding accrued income) increased from $104,006 on

November 30, 1893 to $2,830,616 on March 15, 1928, on which date the par value of certificates outstanding was $2,108,600, owned by about 550 persons. The appraisal value of a $100 par share on February 29, 1928, was $239.40. The fund has paid dividends at rates varying from 4 to 8% on shares outstanding, and in 1902 paid a 50% stock dividend. The actuary of the trust states that the trust, which has never been advertised, "was organized for the purpose of giving persons of small means an opportunity to invest in diversified lists of securities held by a trust which was managed by professional trustees which is a regular line of business in Boston. The general investment policy was similar to that which would have been adopted by these same trustees if they were trustees under a will which gave them the broadest powers of investment."

Often stated to be the oldest, is a much younger trust established in Philadelphia in 1907. It is the Alexander Fund, an unincorporated association registered with the Pennsylvania state banking department, and built largely upon the personality of its founder. He accepted funds for joint investment, first from a circle of immediate friends, later from an increasing number of investors. The informal structure of his trust shows the influence of the fact that Pennsylvania citizens for years had been educated to a knowledge of building and loan associations. The fund (which is held by a bank) issues two series a year, in units of $100, with a return beginning at 6%. These series participate in a pool or common fund as determined by the market price of the investments in the fund at the time they are offered. Participants may withdraw on demand and receive the value of the unit on the date of withdrawal. The manager receives 10% of income and profits for his services, and the fund bears a moderate expense for rent, clerical help, printing and postage. The fund began with four participants and $1200, and on February 1, 1928 had 39 series outstanding, with total assets of $2,612,474.82, which included $1,818,100 deposited by 883 participants. Despite the limited attempt made to appeal to the public, the growth of the fund has been especially marked in recent years. The manager operates separately The Securities Fund, The Marginal Trading Fund and The Alexander Savings Account.

Still different in structure is the Fidelity Investment Association, formed in West Virginia in 1911. This organization does nothing but sell what it terms a special annuity contract providing monthly payments by holders in the accumulation of an estate. The estate ranges from $2,000 to $20,000 and is paid to the holder in annual instalments. The holder also participates in the surplus earnings of the reserve maintained to mature all contracts, which has been estimated to be $200 on each $2,000 contract. In addition, liberal loan, paid up and cash privileges are available. On December 31, 1927, it showed reserves of $12,558,981 for the maturity and payment of contracts outstanding, as well as capital stock of $307,500 (held by 59 stockholders) and undivided profits and special reserves of $503,560. Most of its securities are deposited with state insurance authorities for the exclusive protection of contract holders.

More nearly along present lines is the First Investment Company formed in 1916 at Concord, New Hampshire. Since 1925 it has had outstanding Class A shares—a preferred receiving 6% dividends and $50 in event of dissolution, but participating equally in event of further distributions with the Class B stock held exclusively by the directors. It has broad investment powers, merely limiting investment in one security to 10% of its funds. The total assets on December 31, 1927 amounted to $1,000,868 (of which $831,150 was represented by Class A shares), as compared with only $594,069.51 on December 31, 1926. The treasurer of the trust characterized it as follows:[4]

"The picture I would like to give you is that of a group of conservative outstanding New Hampshire men experienced and successful in financial affairs working on what we believe to be a sound plan, so that the seven hundred odd stockholders of large and small means may possess a sound investment returning better than the average income. We have been working away on this for eleven years now, gradually expanding as we increase our experiences and abilities. We hope to be able to continue the growth in size and to satisfy our stockholders."[5]

THE EDGE ACT

The close of the war found the United States with a greatly expanded foreign trade. This had been financed in several ways: first, by the shipment of gold by Europe to the United States; second, by resale to the United States of American securities held abroad; third, by sale to the United States of foreign securities; and fourth, by direct borrowing from the United States on governmental as distinct from private obligations.[6] The war torn nations further required large quantities of goods for purposes of

[4] Letter quoted in Grayson, p. 164.

[5] In addition to the organizations here cited, several present-day trusts took over other companies formed at an earlier date. Thus the Guardian Investors Corporation acquired the Central Utilities Corporation, established in 1912, while the American European Securities Company took over a Swiss company established in 1910. Some tabulations also list a number of other early companies, especially in the public utility field.

[6] See the annual studies of the balance of international payments prepared by the United States Department of Commerce, the Federal Reserve Board and the Harvard University Committee on Economic Research.

reconstruction, in addition to foodstuffs; yet they possessed no immediate capacity to pay. How to furnish them on credit the goods they required, was actively discussed. The favorite solution was to pay American exporters cash, which was to be supplied by American investors who would buy long term securities of European debtors. Thus these countries' productive power could be built up, and they could be put in position to pay interest on and ultimately to repay the principal of their loans. At the same time, American export trade would be sustained, and American industrial activity maintained at high levels.

The difficulty with this suggestion was twofold; first, the borrowing nations were particularly the newly created succession states, rather than the older nations, hence of poorer credit standing; second, the American investor—often a newly created small saver—was unacquainted with foreign securities, and in little position to judge them, hence timid about buying them. Accordingly the investment trust was proposed as an indirect means of selling these foreign securities to American investors, and therefore an adjunct to our foreign trade. The Federal Reserve Bulletin, for example, in its November, 1920, issue contained an article entitled "The Investment Trust as a Channel for Investment Abroad." Already early in 1919 the same idea had been advanced, for example, by Leopold Frederick in an article in the Bankers Magazine for April. It was believed that, while American investors might not buy foreign securities, they would buy securities of American corporations, even though the latter's assets consisted solely or largely of foreign stocks and bonds.

In response to these oft expressed views, heightened by the fall in foreign exchange rates, the Edge Act was passed by Congress and approved December 24, 1919 (amended in certain particulars in 1921). This legislation took the form of an amendment to the Federal Reserve Act by adding a new section 25-a. It provided for the formation of Edge Act corporations whose stock might be held by member banks of the Federal Reserve system. These corporations were to be chartered by the Federal Reserve Board, were subject to the latter's general oversight and supervision, and were to operate only in accordance with the provisions of the Act and the Board's regulations issued thereunder. The Act does not specifically distinguish several different types of corporation, but the Board recognized two classes, and required a proposed corporation to select either class of business, but not combine both. One was intended for short term or acceptance operations in connection with imports and exports of goods, while the other was to operate along the lines of a British investment trust or financing company, especially the latter. The second might hold obligations, stock or other certificates of ownership of corporations engaged in foreign business, up to 15% of its capital and surplus in banking institutions and 10% in business undertakings, and might offer foreign securities for sale.

Edge Act corporations of either type must have the rather high minimum capital of $2,000,000, all of par value but of several classes if desired, and at least one fourth paid in cash before business is commenced. They are required to set aside 10% of net profits half yearly to surplus until the latter equals 20% of capital. In addition, they may have outstanding aggregate liabilities on account of debentures, bonds and notes up to ten times their subscribed capital and surplus, and the Board may permit a greater amount. The Federal Reserve Board required its approval of any public or private issue, other than for notes for temporary bank borrowing of a maturity not to exceed one year. It further required a detailed list of any security and the general nature of the transaction upon which the issue was based, as well as absence of reference in circulars and advertisements to Federal Reserve Board approval of the issue. In a similar way, it required approval for sales of foreign securities with the Edge Act corporation's endorsement or guarantee. The borrowing provisions, it should be noted, hearken back to the earlier American mortgage banking idea of a heavy bonding, with a small capital as a protective margin, which was exemplified in the Federal Farm Loan Act of 1916, rather than to the British investment trust idea of a moderate bonding in a balanced capital structure.

The mechanism was thus created. Various bodies, in particular the American Bankers Association, actively sponsored use of the Act in 1919–1921. There was proposed formation of a hundred million dollar Foreign Trade Financing Corporation. But the move proved abortive. As Robinson states:[7] "This idea was basically sound, but the times were unpropitious by reason of these very circumstances which gave poignancy to an appeal for a financing company of this kind. The currents of international trade were too shaken and unsettled; it was difficult to give precise enough definition to the type of service by which the corporation proposed to make fruitful use of so large a capital; the project seemed to over-reach itself and to fail of popular, and even whole-hearted professional, approval. The gray lights of 1921 further dampened the ardor of the promoters, and early in the following year the matter was finally dropped." Only once, in fact, has the Edge Act been availed of for long term purposes. In May, 1926, F. J. Lisman & Co., investment bankers of New York, chartered the First Federal Foreign Investment Trust. It has not bor-

[7] P. 253.

rowed to the limit permitted, while it has interested itself in financing as well as in investment operations.

In the meantime, several investment trusts looking particularly to the foreign field had been organized under state law. In general, however, they partook rather strongly of a financing instead of a pure investment character. In 1915 the National City Bank interests had organized under New York state charter the American International Corporation, which possessed broad powers of dealing in foreign and domestic securities, exploiting natural resources and developing foreign trade. Under the spur of wartime opportunity it engaged actively through affiliated contracting and trading companies, in foreign engineering, shipping, construction and commercial enterprises, which it financed directly or through resale of bonds to the public. But the great fall of security prices in 1920–21 "froze" a large part of the corporation's assets and those of its subsidiaries, and it has only recently succeeded in completing liquidation of these concerns. The concern recapitalized in 1924 and has become more and more of an investment trust.

In 1916 the American Foreign Securities Corporation was formed in Delaware. It issued and sold to the public $10,000,000 of 5% collateral trust notes, which were secured in turn by a deposit of bonds pledged by the French government, with a market value of 20% in excess of the principal of the notes. Thus it involved a loan to the French government. The Morgan interests organized the Foreign Finance Corporation under New York law, while in 1919 a group of prominent American bankers organized the Foreign Bond and Share Corporation under Delaware law to finance enterprises in Latin America, the Far East and Europe. Concerning the former's operations, little is known, while the latter became inactive after several of the interested financial group withdrew. In 1920 was organized the Overseas Securities Corporation, which was succeeded in 1923 by a new "trust" that took over its less readily liquidated holdings. This was largely an investment organization, which held in the neighborhood of 100 different securities, but which also engaged in brokerage and foreign exchange operations.

A PIONEER TRUST—THE INTERNATIONAL

In April, 1921, was organized the International Securities Trust of America. This enterprise rather than any of the organizations already mentioned, was to be a conspicuous success and pave the way along which later investment trust development in the United States followed. Many waited for it to undertake the initial experimentation, and its success—in point of mere size, it and its affiliated trusts constitute the leading group today—attracted a host of imitators. Various of its characteristics have therefore served as models for later trusts. Structurally, it was a British or corporate type, issuing bonds, preferred and common stock. It employed a dual set-up—a fiscal agent to sell the trust's securities and to provide investment information and accounting service, in addition to the trust itself. It emphasized the importance of an independent investment position, not under the domination of any investment banking house, but this position was probably due at the outset to the general skepticism of the investment banking community, rather than to deliberate choice on the part of the organizers. The investments were to be widely diversified (including at least 400 issues and bonds as well as stock) and world wide in scope and were to be changed as conditions dictated—far more rapidly, it appears now, than British practice provided. They were to be selected and changed on the basis of the work of an elaborate statistical staff, devoted to the analysis of security issues. In all these directions, covering structure as well as investment, the trust's practice has served to guide later American development.

The trust began as a Massachusetts trust, with a little known group of people, selling units of preferred and common stock continuously through dealer contacts which it built up. It showed but little progress before 1923, when it was reorganized. The Commercial and Financial Chronicle, in fact, contains no items on the trust before the third quarter of 1924. The Bull & Rockwell Company served as the first fiscal agent, but was succeeded at the opening of 1925 by Bull Bros. & Co., and somewhat later by the American Founders Trust, which had already been organized in January, 1922. The latter was at first compensated by an option to buy common stock at a fixed price per share, but this was commuted in December, 1926, into purchase for cash of the entire remaining issue of Class B stock, and in addition it received 4% of gross earnings after taxes, plus a moderate cash commission on sales of the trust's securities. It expanded into a considerable investment trust itself, although of a more adventuresome character than the International, and its assets increased from \$4,445,000 on November 30, 1925 to \$15,531,000 one year later and \$25,180,000 on the corresponding date in 1927, or \$33,366,000 after giving effect to subsequent financing. It became recognized as the center of the group, to act as fiscal agent for the several trusts. The International itself was converted into a Maryland Corporation in June, 1927, and shortly thereafter Harris Forbes & Company floated extensive issues of its debentures and held several places on the board of directors. In October, 1926 the Second International Securities Corporation of America was formed under Maryland law, and was financed through the American Founders Trust until it had assets of $6,448,000 on November 30th of that year, as compared with $15,391,-600 one year later, or $22,396,000 after giving effect to subsequent bond financing undertaken by Harris Forbes & Company. A new development in the group is the formation of the United States & British International Securities Corporation under Maryland law in January, 1928, in coöperation with certain British interests, which was designed to have assets initially of some $16,296,000. Finally, as of October, 1, 1928, the American Founders Trust was transformed into a corporation.

The growth of the International itself is most vividly shown by a few figures. Total assets increased as follows:

November 30	*Amount*
1922	$ 6,000
1923	367,000
1924	1,428,000
1925	6,820,000
1926	25,476,000
1927	47,544,000 *

* $57,651,000 after giving effect to subsequent financing.

Earnings likewise showed tremendous growth, due in part to the excellent opportunities existing during the period for profitable investment.

Period	*Applicable to Bond interest*	*Bond interest paid*
Inception to Nov. 30, 1923	$ 8,736	$ 1,690
Year ended Nov. 30, 1924	74,586	16,978
" " " " 1925	375,268	97,026
" " " " 1926	1,994,086	364,018
" " " " 1927	3,416,853	596,845

The dividend record also bears eloquent witness. As earnings and hence dividends increased, the market value of the stock rose greatly. Dividends are shown herewith:

Period	*Amount of each (quarterly) payment*	*Equivalent on original shares*
June, 1923–June, 1924	1.25	
September–December, 1924	1.50	
March, 1925 *	.60	1.80
June	.65	1.95
September	.70	2.10
December	.85	2.55
March, 1926	.95	2.85
June	1.05	3.15
September **	.39	3.51
December	.42	3.78
March, 1927	.45	4.05
June	.48	4.32
September	.52	4.68
December	.55	4.95
March, 1928	.55	4.95
June	.55	4.95

* Stock split December 13, 1924, 3 for 1.
** Stock split July 24, 1926, 3 for 1, so that one original is represented by 9 present shares. Dividends shown on class A stock.

Dividends on Class B common (held by the fiscal agent) were instituted September, 1927 in the quarterly amount of 12½ cents per share. The earnings and stock dividend record (one original was represented by 45 new common shares before the recent conversion into a corporation) of the American Founders Trust has been even more spectacular.

BANKERS' SHARE COMPANIES

The International was founded, in many ways, upon British models. An early American variant in form and method of operation was the bankers' share company. This organization issued shares or certificates evidencing pro rata participating ownership of securities deposited with a bank or trust company that acted as trustee. These securities were as a rule common stocks of a selected group of corporations and were not subject to any change by either the company or the trustee. Thus the factor of management was avoided entirely, and the investor was further safeguarded by his ability to convert a specified number of shares, generally 1,000, into a unit of the deposited securities.

The idea itself was not new. The Stock Conversion & Investment Trust of London, mentioned in the preceding chapter, was of this general type. The basic idea was much more extensively applied, however, in the United States. An early illustration was in the case of the Ford Motor Company of Canada, Ltd. Here the high priced stock of the concern was deposited with a trustee, and split up into convenient denominations for smaller investors by issuing 100 bankers' shares against every share of Ford stock deposited. This project met with disfavor because of the illegitimate use of the Ford name in sales efforts, and because of the fact that a large spread existed between the sales price of the bankers' shares ($650–$750) and the market price of the underlying stock on the curb ($491–$524 in 1925). The state court stopped the sale of the bankers' shares in April, 1925.

Later companies have offered bankers' shares against a fixed list of securities of a number of companies. In April–July, 1924, Bonner Brooks & Co. of New York offered shares of three trusts: United American Electric Companies, Inc., including ten public utility companies, United American Railways, Inc., representing stock in seventeen common carriers, and United American Chain Stores, Inc., representing stock in fourteen chain store systems. The bankers' shares were also offered simultaneously in London. It was announced that application would be made to list them on the New York Stock Exchange, but approval was withheld, owing, it has been said, to their non-voting character. The governors of the Exchange passed the following resolution:

"Resolved, That participation by a member of the Exchange or Stock Exchange firm in the formation or management of investment trust corporations or similar organizations which in the opinion of the Governing Committee involve features which do not properly protect the interests of investors therein may be held to be an act detrimental to the interest or welfare of the Exchange."

The active sale of the shares is said to have ceased shortly after this announcement, and gradual reduction of the outstanding shares took place as the bankers took up securities held against shares they had bought back in the market. On March 26, 1926, liquidation of the three trusts began. Partly this was due to the absence of listing. Partly it resulted from the favorable market at the moment, which showed considerable appreciation above original issue price, but which presented an uncertain outlook due to the inelastic character of the trusts. Contributory was the number of shares which flowed back on the market into the bankers' hands, and the small margin of profit. The latter was estimated to be $1.25 in the case of the railway bankers' shares selling at $14, of which 65 cents went to the banker who sold at retail, 15 cents to an English syndicate which sponsored the shares here, 24 cents to the trustee for its services in perpetuity, and the remaining 21 cents to the underwriters.

The real leader was the American Trustee Share Corporation, sponsored by Throckmorton & Co., of New York, who had about the opening of 1924 offered United Bankers Oil Co., consisting of shares in ten Standard oil companies. It was incorporated in New York in May, 1924, and first offered Industrial Trustee Shares, consisting of common stocks of ten companies in practically as many different industries. In April, 1925, it issued Diversified Trustee Shares, composed of twenty-four companies, and in December, 1927 issued in addition a second series of Diversified Trustee Shares based upon twenty-four other companies. Its effort has been concentrated upon the Diversified Trustee Shares, of which there were $9,620,000 outstanding in the autumn of 1927, as compared with only $130,000 of Industrial Trustee Shares. The importance of this company in the movement arises from the fact that it has had a very large distribution, and its methods have been widely adopted by other trusts of a similar nature. The salient features are a general list of securities, compensation consisting of the initial spread between the cost of the underlying securities and the sale price of its shares to the public, continuous sale through active wholesale distribution, and use of extensive literature designed to acquaint the public with this so-called ''American type'' of trust. Other trusts of this type included the Nation-Wide Securities Corporation, formed in 1924 by Calvin Bullock of Denver, the Investors Trustee Foundation of the United States, Inc., formed in 1927 by Jordan, Colyer & McGuire, Inc., of New York, and the American Basic

Business Shares Corporation, formed in 1927 by F. J. Lisman & Co. of New York.[8]

Two variants of this type have since appeared. The first follows the general principles already mentioned, but grants the management discretion to replace any of the named securities with others selected in accordance with restrictions laid down in the declaration of trust. The New England Investment Trust, formed in September, 1925, first advanced this idea, and had a considerable vogue, having $5,520,000 worth of its Collateral Trustee shares outstanding at the middle of 1927. It also introduced extensive retail sales efforts through its own retail staff. In April, 1927, the United States Shares Corporation was formed by a former vice president of the New England Trust to operate a general trust, a bank stock trust and a foreign government bond trust, the first two of which have had considerable success ($1,221,665.94 outstanding in the middle of 1927) and added others subsequently with modifications dictated by experience. Later in that year the Investment Corporation of North America and the Investment Trust of New York, Inc., were organized to operate general trusts.

The second variant was that of a specialized instead of a general list. It had already been found in the Bonner Brooks trusts, and in 1925 the Financial Investing Co. of New York, Ltd., had offered Foreign Government Bond Trust Certificates with moderate success. One of the two outstanding recent examples is the United States Electric Light & Power Shares, Inc., organized by Calvin Bullock in April, 1927. This is a fixed trust which has had widespread distribution, the amount outstanding increasing from $9,800,000 on December 31, 1927, to $17,546,639 on

[8] By the autumn of 1927 the Investors Trustee Foundation had $1,350,000 outstanding and the Lisman trust $289,000. The latter had well over $6,000,000 outstanding in July, 1928, after its first year of operations.

March 31, 1928. The other is the Insuranshares Corporation, formed in New York in March, 1927. This is a managed trust, which concentrates attention upon insurance stocks, abandons the unit device and regards itself as a fund rather than a bankers' share company. It has issued several series, instead of selling one trust continuously. It has also introduced the plan of separating the management's compensation from the creation and sales expense, and making the former contingent upon the results shown. On March 1, 1928, it had outstanding five series of its certificates, amounting to $8,050,000 par value, as compared with $4,150,000 in the previous autumn.

What, it may be asked, is the reason for the growth of this type of trust? Its appeal lies in its apparent simplicity, publicity and definiteness, coupled with the security afforded by trustee custody of the securities safe from either any managerial tinkering at all, or else tinkering only within specified limits. Added to it is the thought of growth with the United States or selected industries, such as finance or utilities, through common stock holding. The shares were offered at a low price and designed to make a wide appeal. A further practical factor is the ability of a company with small financial resources to create such a trust.

THE BOOM PERIOD OF TRUST FORMATION

It was already observed that interest in investment trusts revived about 1924. New trusts began to be formed in increasing numbers. In part, the success of the International proved a dazzling attraction. Moreover, the record of the securities markets in recovery from the lows of the depression renewed confidence, and seemed to point to even greater opportunities in future. The rapid debt retirement (some $8,000,000,000 up to 1928) and readjustment operations released huge amounts of funds, which to the small saver presented a serious investment problem. It is also undoubtedly true, as Anderson states,[9] that "in the absence of the great expansion of credit which has taken place, the investment trust movement would have developed much less rapidly than has been the case," with less severe competition for investors' money and much more critical scrutiny by investors of the types of securities offered them. But perhaps, as Atwood states,[10] "the investment trust may have sprung up, not so much in response to the other causes mentioned, but as a mere manifestation of a bumptious bull market." The gospel of appreciation in market price, rather than current yield, has been increasingly accepted. It should be remembered, however, that England had a parallel movement of trust formation during these years. Without doubt a factor in both cases has been the realization that relatively high yield investment opportunities existed on the continent, often too hazardous for individual selection and holding. These security values have been improving with the return to financial stability, at the same time that the American industrial outlook in 1927 slackened perceptibly.

A large and increasing number of trusts was formed, and an increasing diversity of structural types and of practice noted. The result of the increase in numbers was that in the summer of 1927 the Attorney General of the State of New York estimated the number of trusts as well over 135, with a paid-in capital probably in excess of $400,000,000, and at the opening of 1928 approximately $600,000,000. The following table summarizes the dates of formation of 121 trusts listed in Moody's 1927 volume

[9] Chase Economic Bulletin, Vol. 8, No. 1, June 4, 1928, An Analysis of the Money Market, p. 24.

[10] The Saturday Evening Post, April 28, 1928, p. 13.

on financial institutions, omitting holding companies and trusts formed in Canada. The list is obviously incomplete, but affords an indication of the growth which has taken place.

Number of investment trusts formed, during specified years, by types

	Corporations General	Corporations Specialized *	Bankers Shares and Allied types	Funds	Total
1893–1913	1			3	4
1914–1921	7				7
1922	1	1			2
1923	–	1	–	1	2
1924	5	–	3	2	10
1925	11	1	3	2	17
1926	11	1	1	1	14
1927	28	7	12	5	52
1928 first quarter	10	2	–	1	13
Total	74	13	19	15	121

* Largely confined to bank and insurance company stocks.

The list in Keane's Manual is more extensive, in that it includes some smaller and lesser known trusts, especially of the corporate variety. In 1926 it shows thirteen corporate trusts formed, one bankers' share type and three funds, but in 1927 shows respectively 46, 16 and 5, and in 1928 19, 1 and 4. Fowler's tabulation shows 18 trusts organized from 1889–1923, 17 in 1924, 26 in 1925, 26 in 1926, 91 in 1927 and 49 during the first six months of 1928. Of these, 199 were in existence at the middle of 1928, with an estimated invested capital of $1,200,000,000. From the opening of 1924 thru the first half of 1928, incomplete figures of public offerings tabulated from the Commercial and Financial Chronicle equalled $537,316,000, of which $185,-150,000 represented bonds, $223,518,000 preferred stock and the remaining $126,648,000 common stock. Of the 199 trusts, 146 were corporations; and corporations represented 80 per cent of the entire invested capital of $368,-000,000 of 57 investment trusts reported by the Attorney General of the State of New York.[11]

Trusts have been formed in a variety of directions. The independent groups on the whole have not been prominent. Some trusts have been formed largely for sales purposes and some by well meaning people attracted by the lure of public interest. Some investment counsel and professional trustees, largely in Boston, have organized funds in which the public is invited to participate. More important, investment bankers have opened their eyes to a number of advantages. Partly they hoped not to lose their clients, partly to render real service, partly to seize upon a new sales device and partly to reach new clients. They expected to sell large issues of investment trust securities, and could run the trusts so created figuratively if not literally in a corner of the office. Some of the leading houses therefore formed trusts as a sort of subsidiary, while some coöperated with other domestic and foreign banking houses in trust formation. Thus Dillon Read & Company participated in the United States & Foreign Securities Corporation, Brown Bros. & Co. and Stone & Webster & Blodget, Inc., in the Standard Investing Corp., Brown Bros. & Co. and Lee Higginson & Co. in the Continental Securities Corp., Blyth, Witter & Co. in the American, British & Continental Corp. and the Pacific Investing Corp. These trusts largely followed the general pattern of the International, with the investment banker more or less in the same relative position as the American Founders Trust. Their interest has often been largely in foreign securities, and they often represent a recrudescence of the foreign financing investment trust.

[11] Pp. 6, 34–35. See also a tabulation of 157 trusts made in June 1928 by Stone & Webster & Blodget, Inc.

Small local securities dealers, meanwhile, have not been idle. They and their customers had been educated to investment trust securities, and reasoned that they might as well sell their own trust, which they then created, patterned on an existing plan. Especially have they been active in 1927 and 1928. The danger lies in the fact that they often possess largely a sales attitude and have little real knowledge of either investment trust principles or security values.

Another group of trust organizers consisted of banks. Some banks formed subsidiaries, not to deal in securities, as does the National City Company or the Guaranty Company of New York, but rather to handle the miscellaneous transactions in second mortgage loans, pieces of financing, etc., which the bank could not undertake, as well as to hold securities. Many therefore properly cannot be termed investment trusts at all, excepting those created by Boston banks. This movement has been especially pronounced in the case of New York banks, where the Financial & Industrial Securities Corporation formed by the Manufacturers Trust Company pointed the way. The pioneer Bancitaly Corporation formed by the Giannini interests of California has been the other conspicuous example. It has been but a step from these to the formation of hybrid bank holding companies, which follow the old chain bank idea of controlling banks, but have been sweetened with an investment trust flavor to appeal to popular fancy. Public interest in bank stocks, with their rapid increase in price, has made these trusts seem extremely attractive.

THE TRUST REGULATION MOVEMENT

The recent rapid growth of trusts has caused doubt to arise in certain minds. They profess to see a parallel with English conditions in the late 80's. This attitude is reflected in the position taken by American securities commissions. Many states have blue sky laws that require security issues to be submitted to the commission for approval before being offered for sale in the state. Some states further require dealers to be licensed. These commissions of necessity have had to evolve certain standards in testing applications to license investment trust securities. Some states license none, as in Nebraska, but others license almost all applicants. The great trouble is that no two agree fully as to exactly what is desirable and should be required. Other states have faced the same problem in a different way, for example, New York, whose Martin Act empowers the Attorney General, in case he suspects fraud, to interrogate the dealer and issuer, and if he deems it necessary, to apply to the proper court for an injunction, forbidding sale either of the security or by the dealer.

Accordingly, certain states instituted special investigations of investment trusts. Most conspicuous was that of the Attorney General of the State of New York, during the summer and autumn of 1927. His "survey" cast some reflection upon certain aspects of the movement, and the resulting widespread doubt and hesitancy was not removed by the "supplemental survey" he issued some months later. He embodied his conclusions in a bill proposing regulation by the state banking department, but the bill was not enacted by the legislature. Many New York city investment bankers opposed it because they feared an entering wedge of general blue sky legislation controlling security issues. This difference of opinion as to proper procedure did not serve to reassure the general public. Other states either waited to see the outcome in New York, or else, as in California, New Jersey and Maryland, instituted investigations of their own, and, as in California and Utah, prepared special regulations to which trusts must submit.

This year, the National Association of Securities Commissioners has displayed considerable interest in the matter. On their own part, the investment trusts had been divided in their views, and the several proposals for the formation of an association among them never had much hope of success.

THE TEST PERIOD

The result of the New York investigation was a certain attitude of suspicion by the public. Nor was the appointment of a receiver for the New England Investors Shares, Inc., (successor to the New England Investment Trust) in March, 1928, calculated to reassure them. Investors who had paid in part for shares discovered that the former management had made off with their funds, and sought redress against the trust fund, but the Federal Court held the latter inviolable to the fully paid share holders. High security prices in the earlier part of 1928 further caused many investors to liquidate their holdings of trust securities, as well as to hesitate in making further commitments at such levels. In the face of this situation increasingly keen competition existed for the investor's dollars, and a goodly number of trusts seemed more concerned with devising ways of parting him from his money than with devising means of protecting it once they obtain it.

At the present writing (October, 1928) a new period of American investment trust history appears to be beginning. For want of a better name, we may call this the period of testing. The sharp break in the stock market in June served to shake the faith of the public in stocks as a means of getting rich quick. The sharp fall in several bank holding company and investment trust issues served to dampen the ardor for investment trust securities. The public attitude towards such securities changed. Little speculative interest in them has existed recently, and their prices have not followed the upward course of general stock prices. The trusts themselves have emphasized liquidity to an increasing extent, and do not appear to have tried to ride the crest of the recent wave of general speculation. Reflecting this changed situation, new investment trust issues during the summer and autumn of 1928 have been rare, the close of October alone showing any activity. A number of projects, conceived at an earlier time, but not yet completed, await a more auspicious moment for launching. At the same time, the investment problem of many trusts, brought into being with none too experienced or conservative a management, has increased measurably in difficulty. Faced with a clientele of investors whose hopes were raised to a high pitch in a wave of speculative enthusiasm, they are asked to fulfill these expectations in a securities market whose tone is irregular and extremely sensitive, and which is often regarded as "high." How they will fare in a bear market, remains to be seen. Already some of the weaker are disbanding; the hopes of the promoters for the volume without which no trust can survive were not realized, capital was inadequate, or investment problems were too difficult. In part they are consolidating, in part folding their tents like the Arabs. More will follow. Yet today others stand ready at a moment's notice to take their place, but less confidently than some months ago. Exactly what the future has in store, time alone can tell. We can merely remark here that we are entering upon the most interesting—and at the same time probably most difficult—stage in the movement.

A concrete illustration of the problem facing the trusts, and the public attitude towards their securities, is shown by the tables on pp. 68–69, prepared from the data given in the New York Times, and arranged by type of trust. The figures are bid and asked prices as of approximately the first of the month.

SELECTED REFERENCES

Fowler, pp. 4–19.
Grayson, pp. 131–146.
Robinson, Ch. XIII, American Financing Companies, pp. 230–263; Ch. XVI, Recently Organized American Investment Trusts, pp. 299–331.
Speaker, Ch. V, The Investment Trust in the United States, pp. 69–89; Ch. VI, The Use of the Investment Trust in American Investment Abroad, pp. 90–98.
Smith, J. G. The Development of Trust Companies in the United States, New York, 1928.
Atwood, A. W., Changing Fashions of Finance. The Investment Trust, Saturday Evening Post, April 28, 1928.
Robinson, L. R., The Investment Trust in the United States. The Latest Development in American Finance. Stock Exchange Gazette, May 13, 1927, reprinted in Keane, pp. 551–555.
Current American newspapers and periodicals listed in Bibliographical Note, especially
Commercial and Financial Chronicle (weekly)—
(1) Reprints of addresses and articles,
(2) Items with respect to individual trusts.
Journal of Commerce, New York (daily).

1927	Corporate Type: American Founders	International A	International B	Second International	Financial Investing	Continental Securities	First Federal Foreign	United States and Foreign
Jan.		35½–36¾			17¼–19¼	52–60	95–	
April		40 –			18 –20	58–62	105–110	
July	52–62	59 –62		43½–47½	19 –21	70–74	105–	18–20
Oct	65–69	60½–64½		49 –53	22 –24	70–74	105–110	19–22
1928								
Jan.	82–86	72½–76½	33 –37	54½–58½	23 –25	81–85	102–106	17–29
April	95–98	68½–71½	34½–36½	51 –54	24¼–26¼	124–	104–107	22⅛
May	140–145	82 –85	43½–45	59½–61½	24¾–26¾	127–129	106–109	31
June	130–135	75 –78	44 –47	57 –60	26¼–28¼	125–130	107–110	30⅝
July	101–110	65 –71	36 –43	50 –56	26¼–28¼	122–126	103–107	25
Aug.	108–114	61 –67	37 –42	49 –55	26¼–28¼	113–118	——	24⅞
Sept.	115–121	60 –65	35 –40	49 –54	26¼–28¼	107–112	95–100	29
Oct.	57½–60½	* 58 –61	34 –37	49 –52	28 –	109–114	98–102	29
Nov.	62¾–65¾	58 –61	32½–35½	50 –53	26¼–27	118–122½	98–102	43½

1927	Fund Type: Incorporated Investors	Fund Type: Massachusetts Investors	Bankers Share Type: Diversified	Bankers Share Type: United States Shares A.	Bankers Share Type: Insuranshares A.
Jan.	108 –110		16⅞–17⅝		
April	107½–109½	68¾–71	18⅛–18⅞		
July	111½–113½	78⅛–74⅜	18¼–19	12⅛–12⅝	20⅜–
Oct.	125½–127½	80⅝–82⅞	21¼–22	13¼–14	23 –

* Two shares of stock in the new corporation exchanged for one in the old trust.

1928					
Jan.	128 –130	84⅜–86⅝	20⅝–21⅜	13⅝–14½	24¾–
April	135 –137	89 –91¼	20¾–21½	12⅞–	24⅝–
May	139 –141	90⅜–93	21½–22¼	12¾–	25 –
June	72 –74 **	90½–92¾	22 –22¾	13¼–	26½–
July	67 –69	84⅞–87½	19⅞–20⅝	12⅛–	24⅜–
Aug.	68 –70	86½–88¾	20⅜–21½	12¼–	24½–
Sept.	74 –76	87½–89¾	21¼–22	12⅞–	24⅝–
Oct.	75½–78	92⅞–95⅜	21½–22¼	12½–	25¼–
Nov.	76½–79	46⅝–49⅛ ***	21⅛–21⅞	12⅝–	25¼–27

	Financial Companies		
1927	Bancitaly	Financial & Industrial	Dow Jones Average (20 industrials)
Jan.	90⅞	38 –	155.2
April	110½	46 –47¾	160.7
July	121⅜	99¾–101¼	168.1
Oct.	105½	119½–121½	198.4
1928			
Jan.	138¾	111 –114	203.4
April	191½	111½–113½	209.3
May	218⅝	114 –115½	213.5
June	214½	144 –147	220.3
July	117	113 –115	208.2
Aug.	114⅞	111 –112	216.8
Sept.	141½	115½–117	240.4
Oct.	123⅜	114 –115	240.0
Nov.	120½	124½–126	255.2

** 100% stock dividend declared as of June 1st

** Two new no par shares exchanged for each $50 share as of October 20.

CHAPTER IV

INVESTMENT TRUST TYPES

British trust practice has become standardized to a considerable degree. From the variety of forms and practices employed on various occasions there has been left—due partly to accidental circumstances, partly to demonstrated merit—the corporate form which follows a rather well defined investment policy. Not so, however, with the American movement. Here, under somewhat different conditions, experimentation is rife, and a variety of other forms and investment policies are also in use. The result has been to make exceedingly difficult any attempt to classify investment trusts,—as difficult, in fact, as to define the term "investment trust." The various attempts at classification which have been made bear witness to the truth of this statement.

No single basis exists on which to classify investment trusts. Instead, a three-fold choice at least is offered—legal form, investment policy, and structure. Legal form is of little importance of itself, for it matters not whether the trust be organized as a common law (Massachusetts) trust, or as a corporation. Legal form becomes significant only insofar as it is related to the general structure of the trust. Far more important is it to know the set up and plan of operation; in short, how money is to be made, and who is to receive the benefit. Otherwise stated, classification of trusts according to investment policy and according to structure throws real light upon trust operations.

STRUCTURAL TYPES

Differences in structure really afford the key to the existing diversity of American investment trust practice. From this point of view, the types are fundamentally two in number.

Some trusts have a corporate structure. The investor buys bonds, preferred and / or common stock of a corporation (or common law trust) which holds securities. They are of the so-called British or Scottish type. Among the best known of such trusts is the International Securities Corporation of America, but this form has also been favored —in fact, used almost exclusively—by the large American investment bankers who have interested themselves in trust formation.

In other investment trusts the investor buys participation in a fund from which he generally is permitted to withdraw at any time, under certain specified conditions. This fund may be of one of four classes:

1. A fund created and operated by trustees, such as the Bond Investment Trust of Harris Forbes & Company or the Massachusetts Investors Trust. Here several individuals are banded together in a Massachusetts trust and issue their certificates to investors. Similar is a fund created by a corporation which issues only common stock and sells this single class of stock to investors. Examples are the State Street Investment Corporation of Boston and the Inland Investors, Inc., of New York and Cleveland.

2. A fund created by a concern which manages it, under agreement or declaration of trust (indenture) with a trust company which holds the securities, etc., comprised in the fund. This is sometimes called a contractual trust, as are also the third and fourth classes. Here the trust instrument defines the terms of the agreement between the

investors and the managers, and the investor buys a certificate of participation in the trust fund. The managers on their part are banded together in a concern in which the investor obtains no participation, and which can create and operate a number of trusts under separate indentures. An example is the Investment Managers Company of New York, which has created Investment Trust Funds A and B.

3. A fund invested in an initial list of specified securities, created by a concern which manages it, under agreement or declaration of trust with a trustee which holds the securities. Here the investor buys a certificate of participation in the securities comprising the trust fund held by the trust company. An example is the United States Shares Corporation. This form differs from the second form only in that the securities are specifically named at the time the investor buys certificates and hence the fund is built up of identical blocks or units of securities.

4. A fund invested in a fixed list of securities deposited by a concern which creates it, under agreement or declaration of trust with a trust company which holds the securities, and in which list no substitution of securities is permitted. This is the so called "fixed" or "rigid" or "stock conversion" trust that issues "bankers' shares." It differs from the third form only in that the list is not subject to change. An example is Diversified Trustee Shares of the American Trustee Share Corporation, distributed by Throckmorton & Co. of New York. Many hold that this type does not constitute a true investment trust.

It should be borne in mind that the work of devising the plan of operation, raising capital by selling the trust's securities to investors, and managing the trust, may be performed either by the trust itself, or else may be divided among the trust and several other concerns. A separate concern created to sell the trust's securities performs the same work as does an established investment banker who creates a trust that he perhaps also operates on his own premises. In the first and second fund types, the managing group theoretically needs no capital whatsoever; it is like the investment counsel who advises clients for a fee as to their investments and changes therein. But in the third and fourth types of fund are applied in addition the general principles of real estate mortgage banking, as exemplified in the Federal Farm Loan System.[1] The concern operating the fund must acquire the underlying list of securities before certificates can be issued for sale to investors. Hence it needs a revolving fund with which to buy the securities it places with the trustee, just as does a land bank, say, which acquires mortgages that it trustees and then sells bonds against.

In other words, if one is to understand the investment trust, he must consider the relations existing between the investors who supply the bulk of the funds and the organizer-managers. Study of structure brings out these relations. He cannot draw too close an analogy with commercial banking. The latter involves the relationship existing between a group of stockholders and the depositing public which entrusts funds to this group. The investment trust, however, involves relationship between a group of organizer-managers and the investing public which entrusts funds to them. This relation between "insiders" and public may be far more complex than in the case of the commercial bank, for the public may hold some of the same classes of securities as do the "insiders," and the published figures of capitalization may show but little as to the relationship existing between the two groups.

[1] Though without guaranty of the security sold to the investor, as in the farm loan system.

CORPORATE TRUSTS

Corporate trusts in the United States—the so-called British or Scottish type—issue bonds and / or preferred and common stock. The key to an understanding of them lies in the fact that in practically every case they involve a *trading on the equity* by the organizer-managers. That is to say, the public puts up the bulk of the funds with which the trust operates. For its funds it receives all the senior securities and gets a part of the common (generally either because it buys units including some common stock or because it receives warrants entitling it to obtain some within or at a certain period of time). Thus it receives a share of the residual profits. The organizer-managers on their part put up only the lesser part of the trust's funds, but receive the bulk of the common stock. Whether they buy, say, a second preferred stock and receive a common stock bonus, or else buy nothing but common, is immaterial; the general principle is the same. They expect to rent or hire the greater part of the funds from the public at a fixed rate, and give the public a "look in" on the extra profits they make by employing these funds, but reserve most of these extra profits to themselves. This direct management profit they make by holding the bulk of the common stock is more important to them than the profit they may make in selling the senior securities of the trust to the public (either through their own specially organized fiscal agent, or through established investment bankers, if they are affiliated with some) or any annual fee they may receive as officers, directors or advisors.

For such a trust, what we may loosely call a "dry" capitalization is but ill adapted. In the United States today, the very incentive in the formation of a corporate trust lies in the "wet" capitalization which is employed.

The common is to reflect the hopes for the trust's success. The British trust operator, to be sure, is today willing to buy preferred and common stock on the same basis as the outside public. He merely trades on the equity with his fellow stockholders against the bondholder. He relies on his command of capital and consequent larger shareholdings to gain some advantage from trust operations. In addition he receives the relatively small directors' fees, while—and this is far more important—he derives an indirect return from investment advice and information he obtains by virtue of his directorship, which he utilizes in his own private operations. The American trust operator, however, desires a more direct promotional return, just as American security distributors in their field desire a greater compensation than prevails in England in floating new trust issues. This compensation he obtains by trading on the equity against the general public.

FUND TYPE TRUSTS

Fund type trusts involve participation in one of the four kinds of fund enumerated in an earlier section of this chapter. The salient characteristic of these fund trusts is that the organizer-managers themselves make no contribution permanently to the fund. They do not expect to gain by trading on the equity, but instead rather by *receiving a fee for service* in setting the plan up and for overseeing its operation in the first three cases. Such fund trusts are thus similar, in some ways, to the trust company which receives and administers trust funds, as well as to the investment counsel.

Such is the actual situation. It is often obscured by the fact that many trusts, especially fixed and managed list trusts, elect to sell their own securities or else are indistinguishable from the investment banking house that creates them, and lump their entire compensation together in one initial payment by the investor. From the funds they receive from the investor they deduct, say, 10% as their total remuneration. This "spread," as it is called, has the defect, in the case of every managed trust, of lumping together two utterly different items. It includes selling cost for the trust securities and investment fee, both for setting up the plan and overseeing its operation. Worse than that, it deducts the management compensation at the outset, before the service is rendered. The investor is asked to commute the management fee—for which the company is obligated to manage the trust for fifteen or twenty years—into a single initial payment. If this amount is large enough to yield a fair return for an efficient service, the fund is impaired considerably at the outset; if it is small, the operators tend to look at management as a minor adjunct to sale of trust shares. In either case, the management is not tied to the trust, as it is when paid in proportion to its performance, as and when it performs. Furthermore, the only incentive for it to continue to manage the trust lies in the hope of continued sales in future, which depends upon ability as well as desire. Cut off sales and the managing company's income disappears, while the incentive to manage is wiped out.

The misunderstanding of this matter which exists all too often is shown clearly in a ruling of the Iowa blue sky authorities. They take a view entirely opposite to that just stated, and refuse to license a trust which provides for a contingent return; instead, they want a definite amount fixed as the managing company's compensation, and want all subsequent income to go to the investors. Yet they license corporate trusts in which the managers stand in a thoroughly contingent position through their common stock holdings.

At times the question has been raised, which method of remuneration of the organizers is preferable—that derived from trading on the equity, as in the case of a corporate trust, or that representing a fee for service, as in the case of a fund type. The answer involves a study of human motivation which the psychologist has not entirely concluded. Trading on the equity provides the spur of profit, as and when realized; but, especially if the equity be thin, the very incentive to gain may lead to speculation and taking of undue risk. On the other hand, the stimulus afforded by receipt of a fee for service varies according to the manner in which the fee is computed. Both the investment counsel and the trustee receive a fee based upon the size of the fund they administer; but the investor can dispense with the services of the one at will, while the other is subject to reasonably close governmental control. The investment trust stands in a somewhat different relation to the investor than either of these. Moreover, some authorities believe that payment irrespective of performance by no means yields the best results, and point to the general experience of trustees in corroboration. They therefore prefer payment in proportion to performance, as and when rendered. But in this case compensation is similar to that received from trading on the equity. Perhaps the only answer that can be given is that human nature differs. One is content to render his best service for a modest return, which another disdains; while one succumbs easily to speculation in order to increase his compensation, which another entirely disregards. If this be so, it serves to strengthen the view that the existence of a single "ideal" form of trust is but a myth.

INVESTMENT POLICY TYPES

Not only is it necessary to consider how the profits will be divided between insiders and the public, but it is equally necessary to consider how these profits will be obtained. In other words, what investment policy is to be followed?

Extreme diversity is found with respect to every phase of investment policy. No one policy provides a magic touchstone, nor is any one universally accepted today. This is due in large part to the fact that scientific study of investment is of relatively recent origin, and hence that little standardization or crystallization of thought has as yet developed. The leading aspects and the diverse practices can therefore alone be sketched here.

Some trusts grant wide discretion to the management, others (known as fixed or rigid trusts) seek to eliminate managerial discretion entirely. The latter "tie up" a known parcel of securities in a more or less attractive package, and sell it to the investor. At the other extreme, some trusts are "blind pools" that publish no investment lists or data as to operations, and ask the investor to repose entire confidence in the management, perhaps as a result of its past earnings record.

Where discretion is vested in the management, it may be hedged about by more or less formal restrictions. In general, it may be stated that, the greater the restriction placed upon investment operations in the interest of safety, the less the opportunity for gain. A balance must be achieved between flexibility and safety. This is no less true for investment trusts than for other organizations, such as savings banks, insurance companies and trustees.

Some trusts have certain standards of diversification, both geographic and industrial. Not more than a specified percentage of assets may be invested in one country or in one industry or in one security. Limitation of the percentage to be placed in one security is, in fact, the sole formal requirement imposed by many trusts, and is the British rule. Diversification, in practice, ranges all the way from 20 common stocks or so, to over one thousand different securities. Some trusts add other restrictions as to the quality of securities that may be bought—perhaps not more than specified percentages in securities of under a certain Moody rating, or prohibition of purchase of non dividend paying or illiquid stocks.

The objective of the management, too, differs widely. Some trusts confine themselves largely to the older investment canons of safety, liquidity and yield (in the sense of current return). Most, however, emphasize appreciation of principal as well. This may be represented merely by an effort to grow with the United States by holding a more or less constant list of common stocks. Or it may involve fairly rapid turnover of the portfolio, with effort to time security purchases so as to accord with market conditions, instead of merely effort to select sound individual issues at attractive prices, as the British largely do. All shades of objective are represented, from conservative investment to more or less radical speculation.

Wide difference likewise exists in the scope of investment operations. Some trusts are exclusively domestic, while others roam the entire world in search of opportunities to lay out their funds. The latter favor the greater range of choice and hold that there is always some market in which security prices are depressed, hence that the process of profit making can go on continuously. Those favoring domestic issues point to the widespread and manifold character of American industry, coupled with the rapid growth of the country. They further contrast the relative ease of obtaining and analyzing full and reliable information as to domestic securities with the difficulty and magnitude of the task involved in watching a variety of foreign markets, many of which show a distinct paucity of information.

Especially in the case of trusts that confine themselves to the domestic field, some trusts evidence further specialization.[2] In deference to the common stock theory now so popular, many concentrate their attention upon, if they do not confine their attention entirely to, common stocks as permanent elements in the investment portfolio. Often, too, they sacrifice diversification in the interest of growth. They specialize in an industry—for example, banking, insurance, public utilities, or oil—believed to afford better than usual possibilities of enhancement. On the other hand, many trusts are general rather than specialized. They have a far broader view, and regularly hold bonds and preferred stock as well as common stock, especially if they operate to a considerable extent in foreign securities. This group of trusts often participate in underwritings, particularly if they are controlled by investment banking houses.

THE NEW YORK ATTORNEY GENERAL'S CLASSES

In part, differences in investment policy correspond to differences in structure. This is evident in the three types from the standpoint of portfolio management that the Attorney General of the State of New York recognizes, as follows: [3]

First—The discretionary or management group where securities may be bought and sold for the account of the trust at the discretion of the managers of the trust or those properly authorized to make such purchases and substitutions. In these cases the investor relies entirely or to a great extent upon the integrity, the knowledge and the ability of the management of the trust for his income and for the safety of his principal.

Second—The quasi fixed or limited management group

[2] One recent trust even concentrates its attention upon southern securities.

[3] Supplemental Survey, p. 8.

wherein an element of management or discretion exists on the part of the managers of the trust but where this power is curtailed to a degree. In this category of trusts come those which specifically or by inference restrict the purchasing of their holdings to securities having definite geographic or economic bounds. Thus a trust based entirely upon bank stocks or upon securities of the United States or Great Britain or upon securities in the chemical or steel or public utility field would by its nature come within this category. We wish to emphasize that in a trust of this character the element of management is not so great a factor as in the case of the first group inasmuch as the investor knows that his funds are used for the purchase of securities within a very definite field and cannot be distributed outside that realm.

Third—This class is composed of those trusts which are of a fixed or rigid nature wherein the element of management plays no part whatsoever and where the trust itself is unalterable. Securities deposited at the formation of the trust remain during its life-time and are incapable of substitution. The investor purchasing a certificate of this type of trust knows for a certainty what securities are purchased with his money and is enabled to check, by means of current market quotations, the value of his holdings and the amounts of the dividends or interest declared upon the underlying security.

The third of these are fund type trusts. The term "quasi fixed or limited management group" applied to the second, is rather inapt; it includes both trusts in which the trustee possesses the veto power over investments, and at the other extreme, those of a corporate or common law set up in which the only restrictions are geographic and economic, hence where management plays a major part. But both involve a specialized, as distinct from a general, investment policy. In the first type of discretionary or management trust, management is paramount—skillful and competent, as well as honest. These trusts generally have broad powers of investment. Formal restrictions are few.

TESTS OF AN INVESTMENT TRUST

From the preceding discussion, it will be evident that no one type of investment trust necessarily represents the ideal, nor is another type wholly to be condemned. Each has certain merits and certain weaknesses. Each therefore has certain uses and certain limitations. The investor should make up his mind as to what he wants, and select the trust accordingly.

Certain tests exist to which any individual investment trust should be subjected. The investor should ask himself the following questions:

1. Are the sponsors honest and conscientious and, no less, are they able and competent? That they be is, of course, fundamental, whether they create a fixed trust or operate a practically unrestricted corporate trust. Investment skill and sources of information are further required in all but fixed trusts, and are indispensable.

2. Is the plan such as to provide the degree of safety and return which the investor desires? The investor should understand the plan by which the trust proposes to make money; in other words, the general investment policy to be followed; and he should be sure it meets his general wishes and requirements.

3. Does the plan provide for adequate retention of part of turnover profits, current interest and dividends, etc., in the trust, instead of paying them out entirely to those interested in the trust? In other words, is the trust property built up, as British trusts have learned to do, so as to provide a surplus and reserve, instead of being merely

maintained or even impaired by distributing currently the proceeds received from the sale of stockholders' rights and stock dividends? The investor should see that a conservative reserve and dividend policy is followed, and should know from what sources income is derived.

4. Does the plan provide for a fair and equitable division of the profits between insiders and public? The investors should understand how much of the total money they put up and how much of the returns they receive. They should recognize that in analyzing trust structure proportions, not absolute amounts, are important. They should not, e. g., be necessarily overjoyed to think they receive gratis one share of common with each share of 6% preferred they buy at $100. The unseasoned preferred may have no equity back of it, and should actually sell for much less than par, say $80. They then pay $20 for a common stock which they would not buy separately at that figure. Moreover, if the organizer-managers get three shares of common for every share that goes to the public, the latter get only one-fourth of the residual earnings. Nor, again, should they necessarily rejoice to think that they receive *all* the profits in a fund type trust created under an indenture; as already noted, the only reason they do so is because they have paid the "insiders" in full at once.

In short, the investor and the banker or other person who advises investors or lends to them against investment trust securities as collateral, should not be satisfied with catchwords, but should demand full data and should analyze those data carefully. This is no easy task. The sales circular and booklet naturally puts the best foot forward, and either omits or passes lightly over information likely to prove embarrassing. And when complete data are available, to make the analysis itself requires a certain background of training and experience. Yet intelligent judgment of investment trust securities itself requires such analysis, if the investor is to purchase a security adequate to his needs. He cannot pause with the mere bond or preferred stock tests of usual description, but must study the entire financing plan instead.

SELECTED REFERENCES

Fowler, pp. 31–37; Ch. XVI. How to Invest in an Investment Trust, pp. 212–225.

Grayson, pp. 33–38; 146–151.

Williams, Chapter VII, Development in the United States, pp. 55–60; Chapter X, The Investor's Yardstick, pp. 76–81.

Attorney General of the State of New York, Survey, pp. 18–19; Appendix II, pp. 124–132.

——, Supplemental Survey, pp. 8–9.

Childs, C. W. Types of Investment Trust Collateral and Securities, Harvard Business Review, Jan., 1927, pp. 207–212.

Robinson, L. R., American Contributions in the Development of the Investment Trust. Opening New Avenues of Development and Coöperation in American Finance. Address before The Bankers Forum of New York. Trust Companies, Oct., 1925, pp. 16.

Smith, E. L. Pertinent Comments on Investment Trusts. Address before Trust Company Division, American Bankers Association, 1927. Reprinted in Trust Companies, Nov., 1927, pp. 575–580, and American Bankers Association Journal, Nov., 1927, pp. 341 ff.

CHAPTER V

CORPORATE TYPE TRUSTS—STRUCTURE

The corporate type trust—also called the British—is by far the most important type in the United States today. The word "corporate," as already noted in the preceding chapter, is here used in an economic rather than in a legal sense. It excludes corporations which have but a single class of capital stock, while it includes common law or Massachusetts trusts issuing several classes of securities.

Legal form is relatively unimportant in comparison with financial structure. Much ingenuity has been expended in devising the financial plans of various American corporate trusts. In order to understand these plans, they should be judged both as to (1) soundness of structure, evidenced by proportion of senior to junior capital, and as to (2) extent of trading on the equity by the organizers against the general investing public. In both particulars, British differs from American practice. We have a thinner margin of junior capital; while our managers seek a direct promotional return by trading on the equity. Both of those facts, too, have a direct influence upon the security forms employed. American practice leads to a considerable "dressing up" of the issue in order to make it appear attractive to the investor.

LEGAL FORM—MASSACHUSETTS TRUSTS

The corporate type trust may be organized either as a corporation or as a common law trust. The latter is by no means a novelty in American business history, but has been used to carry on a variety of enterprises. It is "a business estate in the custody of a trustee, who holds the legal title thereto with the beneficial interest in others who are the beneficiaries."[1] In other words, it is a voluntary association created under a declaration of trust, which is filed with the appropriate public officer. The declaration of trust describes in detail the forms of securities to be issued, the powers of the trustees and the security holders, their rights, and their exemptions. In short, the declaration of trust corresponds roughly to the corporate charter and the trustees to the directors of the corporation. The result is an unincorporated association which is as far as possible analogous to the ordinary corporation.

The common law trust in the United States has had its principal use in Massachusetts, hence the name "Massachusetts trust." Historically, it owes its existence to the fact that corporations cannot hold real estate for investment (mortmain). While the ordinary operating trust actively carrying on an enterprise and controlled by the shareholders, is subject to the same normal Federal and State income taxes and Federal capital stock tax as is the corporation, it may be mentioned that no franchise taxes are levied on Massachusetts trusts except by the state of their domicile. Furthermore, the trust is free from a variety of statutory requirements made of corporations. It is not required to report, nor in many states need it qualify in order to do business, as must a foreign corporation. The trustees can seek court guidance for their acts, which generally involves assurance in advance of their legality,

[1] Stockder, Business Ownership Organization, New York, 1922, p. 213. See also Dewing, The Financial Policy of Corporations, revised edition, New York, 1926, pp. 13–16.

while directions contained in the trust instrument as to liquidation avoid resort to tedious and expensive legal proceedings.

But the trust form possesses certain disadvantages also. The public is unfamiliar with the device, while it understands more fully the corporation whose securities dominate our stock exchanges. Under blue sky laws regulating the issue and sale of securities the trust fares no better, and in a number of states worse, in the eyes of the regulatory authorities, than does the corporation. Furthermore, the corporation may have a perpetual charter, while the trust, under the rule against perpetuities, has its life limited, in New York to a life or lives in being and 21 years thereafter. Finally, the exact legal status of the trust is extremely difficult to determine and has given rise to much litigation and considerable legislation. In particular, the holders of the shares appear to run some danger of being declared, not beneficiaries, but partners in an enterprise, hence possessing unlimited liability. Corporation law has become more standardized.

The earlier advantages which the common law trust possessed in Massachusetts over the corporation have gradually been removed by subsequent legislation, beginning with 1913, and it has declined in relative importance. On the whole, few investment trusts have adopted this form and most of them are in Massachusetts. The Old Colony and Shawmut Bank trusts of Boston, for example, are Massachusetts trusts,[2] as is the Aldred Investment Trust. In 1927, the International Securities Trust of America gave up the trust form [3] and converted into a Maryland corpora-

[2] Declaration of trust of former is reproduced in Grayson, pp. 346–355.

[3] Amended declaration of trust is reproduced in Robinson, Appendix C, pp. 361–376.

tion, while the American Founders Trust, which is a sort of investment trust itself, as well as fiscal agent for the International group, did so as of October 1, 1928.

LEGAL FORM—CORPORATIONS

In England and Scotland and on the Continent, investment trusts are usually organized under the general companies acts, which also provide for incorporation of industrial concerns. English trusts, for example, are chartered under the Companies Acts of 1860 and 1908, as amended.[4] No special public legal regulation or supervision of their activities exists.

American investment trusts may incorporate in one of three ways: (1) under the Edge Act passed by Congress, (2) under the general business corporation laws of the several states, and (3) in some cases under the state banking laws or the special statutes governing investment companies. As already noted in Chapter III, only one trust has been formed to date under the Edge Act. Similarly, trusts neither receive deposits nor pay by check, hence are not required in general to place themselves under the banking law, either in organization or supervision. In practice, therefore, incorporation under the general laws governing business corporations is the almost universal rule, and the charter and by-laws embrace the same general topics as do those of any business corporation.

The choice of the state of incorporation seems purely a matter of expediency. Delaware, Maryland and New York are most popular. The Attorney General of the State of New York showed last year that, out of thirty-three of

[4] Memoranda of association, etc., are reproduced in Grayson, Appendix A, pp. 303–345.

the more important trusts, twelve were chartered in Delaware, eight in Maryland and eight in New York.[5] Of ninety-six British type trusts listed in Keane's Manual, twenty-seven were chartered in Delaware, fourteen in Maryland, twenty-one in New York and seven in Massachusetts, while ten were organized as trusts. The others were scattered widely. Evidently either the home state is chosen (in New York because of the added prestige believed to attach to a corporation formed there) or else a "liberal" state. In Delaware and Maryland broad powers are granted, expense is small, since fees for chartering are low and no annual fee is charged, while the holder of the shares is subject to inheritance tax only in the state of residence.[6]

A few corporate type trusts have a more complicated structure, which partakes of the nature of both the corporation and the common law trust. Simplest, perhaps, is The Investment Trust, operated by the Mutual Investment Company. It is a fund, similar to some of those described in Chapter VIII, held by a trust company as trustee, for the benefit of holders of class A and class B certificates, under terms of a deed of trust between the company and the trustee. The public buys class A certificates, the company class B. The company manages the fund in accordance with the deed of trust and the income is distributed in accordance with the terms therein specified. In The Investment Company of America, the trustees, acting as a trustees' corporation under Michigan law, manage the fund, in legal form a trust under the provisions of an indenture and known as "The Investment Company of America."

[5] Survey, p. 31.

[6] For charter of the Standard Investing Corporation see Grayson, pp. 405–417; for charters and by-laws of the Second International Securities Corporation and the Sterling Securities Corporation, see Fowler, appendix B, pp. 260–307.

SIZE OF TRUSTS

English and Scottish trusts are generally of rather moderate size. A new trust is added when expansion is desired, and a family of trusts thus created. This keeps the operating staff small and affords flexibility in changing rules for the new trusts as experience dictates. Grayson shows total assets of sixty-three trusts as follows:[7]

Total Assets	*Number of trusts*
Less than £500,000	5
500,000 to 1,000,000	8
1,000,000 to 2,000,000	22
2,000,000 to 4,000,000	12
over 4,000,000	16

The largest trust had assets of slightly over £8,000,000.

A somewhat different picture is obtained if stock, whether ordinary, preference or debenture, actually outstanding (not nominal or issued), is considered. Lee presents 1927 figures for one hundred thirty-three trusts, from which the following is summarized.[8]

Stock outstanding	*Number of trusts*
Less than £250,000	24
250,000 to 499,000	21
500,000 to 749,000	15
750,000 to 999,000	16
1,000,000 to 1,499,000	22
1,500,000 to 1,999,000	11
2,000,000 to 2,499,000	6

[7] Pp. 39, 44. Data for 1924, 1925, 1926 or 1927.

[8] Participating Shares in British Investment Trusts, Trade Information Bulletin No. 530, pp. 3–8.

Stock outstanding	*Number of trusts*
£2,500,000 to 2,999,000	9
3,000,000 to 3,999,000	4
4,000,000 to 4,999,000	3
5,000,000 to 5,999,000	1
6,000,000 to 6,999,000	1

Eliminating data for two very small companies, the average for one hundred thirty-one trusts is a little less than £1,170,000, compared with 1,320,000 in 1912 and 1,300,000 in 1922. The reduction is explained as due both to the inclusion of a larger number of companies and the recent formation of new companies.

No detailed figures are available for American trusts. The following table was therefore prepared from the balance sheet and other data contained in Keane's Manual for eighty-four corporate type trusts for which sufficient information is shown, including companies treated in chapter XI, but omitting Canadian trusts. Several large trusts, in fact, are offshoots of banks. The data show total resources as of December 31, 1927, or later in a few cases.

Total resources	*Number of trusts*
$ 100,000 to 249,000	3
250,000 to 499,000	8
500,000 to 999,000	11
1,000,000 to 1,999,000	11
2,000,000 to 2,999,000	10
3,000,000 to 3,999,000	6
4,000,000 to 4,999,000	3
5,000,000 to 5,999,000	8
6,000,000 to 7,999,000	5
8,000,000 to 9,999,000	3

Total resources	*Number of trusts*
\$10,000,000 to 13,999,000	5
14,000,000 to 17,999,000	5
18,000,000 to 21,999,000	1
22,000,000 to 29,999,000	1
30,000,000 to 37,999,000	3
54,000,000 to 61,999,000	1

The study of Stanford University in 1927–8 shows the "arithmetic median" for fifty-eight trusts as three to four million capital. The American trusts on the whole are still smaller in size, reflecting their newness, although one unit —today seven years old—is some fifty per cent larger than the largest British trust. And at the close of October, 1928, announcement was made of the formation of a new trust under the auspices of Dillon, Read and Co., with \$60,000,000 authorized capital.

THE FINANCIAL PLAN—BRITISH STYLE

British trusts have evolved a fairly definite plan of set-up. They issue bonds and preferred and / or common stock. The older theory—dating back to the 80's and 90's—was that fifty per cent of the capital might be raised by debentures, twenty-five per cent by preference and twenty-five per cent by ordinary shares. But there has been some departure from these figures. A recent study by the Department of Commerce shows the following: [9]

	1912	1921	1927
Number of trusts (approximate)	62	77	133
Outstanding share capital (000,000 omitted)	£75	£100	£153
Debenture	38%	34%	35%
Preference	34	34	34
Ordinary	28	32	31

[9] Robinson, pp. 50, 354. Lee, pp. 14–16.

The 1927 figures embrace companies listed on the London Stock Exchange which are apparently genuine investment trusts and in all but two cases have a capitalization of over £100,000. Evidently some average decrease appears in borrowing and some increase in ordinary capital.

But this trend can easily be exaggerated. In part, the average change appears to reflect inclusion in the one hundred and thirty-three trusts considered for 1927 of some of the newer and smaller ones which have as yet not resorted to debenture borrowing. Of the one hundred and thirty-three, thirty-one had issued no debentures, eight no preference, and twenty-two (one of these the British Trusts Association, which is not an investment trust at all) ordinary only.[10] In other words, only seventy-two were full fledged "British type" trusts. This seems to account for the fact that studies of a smaller number of leading trusts (which invariably include companies which borrowed heavily in the periods of low money rates) show a greater approximation to the traditional ideal.

The results of several such tabulations are as follows:

Source	Speaker[11]	Gray-son[12]	Lyon[13]	Financial Times			
				1926–7		1927–8	
Number	(1920)		1927	Eng.	Scot.	Eng.	Scot.
of trusts	50	63	25 **	30	24	30	24
Debenture	39	38.9 *	41.5	41.0	48.9	43.7	49.3
Preference	30	31.4	28.5	29.0	29.8	28.3	30.9
Ordinary	31	29.7	30.0	30.0	21.3	28.0	19.8

* Of which 12.0% were terminable and fixed deposit receipts.
** Capital £60,509,000.

In their articles of association, British trusts usually limit the amount of preferred stock to not over sixty per cent

10 Speaker, writing some years before, states that two out of fifty companies had issued no debentures, five no preferred, but some had neither and only ordinary. P. 34.
11 P. 35.
12 Pp. 40–43.
13 Commerce Reports, July 25, 1927.

of the issued share capital, and less frequently to fifty per cent. Debenture stock they limit to an amount not exceeding the share capital. Heavier borrowings would occasion difficulty in obtaining stock exchange listing, while underwriters and investors would look askance at the trust. Some limit their borrowings to one-third the fully paid capital, others to forty, fifty, seventy-five and eighty per cent. Fifty per cent is a common limitation. "War experience," says Robinson, "has amply confirmed the wisdom of these restrictions."[14]

The organizers of British trusts for years have bought preferred and common on the same basis as the public. Almost universally, the trusts initially issue share certificates, often in £10 denominations, some of the smaller in £1. When fully paid for and no longer assessable, these are converted into preference and ordinary stock, usually in the ratio of sixty per cent and forty per cent respectively, more rarely half and half, but a few into ordinary stock only. These split shares combine the virtues of the two classes of security—safety and participation in growing earning power. And for years the shares have been sold for cash alike to both organizers and public. Once issued—both preference and ordinary—they are transferable as a rule in sums of £1 and multiples thereof.

The fact that British organizers do not seek to trade on the equity avoids the necessity of "dressing up" the security forms offered. Their debentures and preference shares are standard types—simple and straight, rather than embellished with fancy features designed to present special appeals to the investor. They do not need, for ex-

[14] P. 51. Speaker, p. 36, found only one trust in which bonds exceeded stock and there only in the ratio of five to four. Only four of Lee's one hundred thirty-three trusts showed a similar situation, the several proportions being approximately one to one, 1¼ to one, 1½ to one and 2 to one.

ample, special asset and dividend reserve clauses as a substitute for a more substantial junior equity, nor stock purchase warrants attached to bonds to appeal to the businessman investor's desire for future gain.

AMERICAN TRUST STRUCTURE

The financial plan of the American trust is as yet by no means standardized. In fact, a great many different plans exist and many of them are still new and subject to change as experience dictates. Certain investment houses appear well satisfied with the set up they have employed, but others have either modified the plan of an existing trust,[15] or have introduced other features in creating a second trust.[16] Some plans appear systematic, but in others an opportunistic attitude and lack of careful consideration are evident.

Under the circumstances, any composite tabulation of bond and stock proportions is subject to considerable limitations. The Stanford University study fixes the proportions in the trusts it studied at 2:3:3, representing eighty-seven millions of bonds, one hundred thirty-three of preferred stock and one hundred thirty-two of common stock. Hence it favors a fifty per cent increase in borrowed capital, which it says would only bring the borrowing up to the three-way equal proportion of conservative British practice. But many American trusts are new; and the only way in which these figures are arrived at is by combining a variety of different types. An average results which is by no means typical of the cases under review and may easily mislead. This will be evident from the analysis of types of financial plans made below.

15 For example, Continental Shares, Old Colony Investment Trust.

16 For example, Kidder Peabody & Company; National Shawmut Bank; Old Colony Trust Co.

One conscious attempt exists in the United States to grapple with the problem of ideal proportions between the three major classes of trust securities. The Attorney General of the State of New York faced the task in his effort to draft legislation for the regulation of investment trusts in that State. His original survey fixed the maximum ratios at 5:3:2 or fifty, thirty and twenty per cent[17]—apparently the older British model, changed in recognition of the sixty-forty preference to ordinary ratio.[18] This allows for four parts of senior to one of junior securities and appears fair, though not of the strongest for a new enterprise.

But the Attorney General's supplemental survey relaxes the bars.[19] It limits funded debt to three-fifths the total capital funds (one hundred fifty per cent of capital and surplus). Forced to consider legislative expediency, it calls attention to the fact that some well sponsored American trusts which have not, for the most part, issued substantial amounts of preferred stock, have issued bonds to twice the equity capital. It further states that most management trusts have a common stock equity of much less than two-thirds the preferred, in many cases as low as one-fifth, which it opposes as inadequate. It therefore favors one-third, but decides to omit any requirement from the proposed law until the Superintendent of Banks can make a recommendation based upon experience. Thus the favored ratios become 6:3:1 or sixty, thirty, and ten per cent. Surely this is quite a weak preferred stock, if not a bond, due to the thinness of the equity, and an incentive to speculative management. Yet in the final draft of his proposed law,[20] he relaxed the bars still further. The pro-

[17] Including surplus and thus taking common stock at book value.
[18] Sects 1.3; 4.1: pp. 103, 106.
[19] Pp. 26, 27–28.
[20] Reprinted in Keane, p. 776, sec. 480-c, 1.

vision as to the preferred and common ratio continued to be omitted, but the funded debt was to be no more than twice the paid-in capital, surplus and reserves. Assuming no change of heart as to the preferred and common ratio, and disregarding reserves, the maximum ratios become 8 :3 :1 or sixty-four, twenty-four and eight per cent.[21] These three proposals may also be stated in terms of junior assets remaining available for bonds and for preferred as a percentage of the amount of bonds and of preferred outstanding:

Proposal	To bonds	To preferred	To bonds and preferred combined
First	100%	67%	25%
Second	67%	33%	11%
Third	50%	33%	9%

The thinness of the American equity as contrasted with the British goes hand in hand with the difference in investment policy pursued. The British trust, with its conservative set-up, can invest for the long run; the American trust must turn over its assets fairly rapidly if the earnings are to be adequate and if the common is really to be worth anything. For an American trust with the usual set-up to follow the traditional British investment policy would be suicidal, as is indicated in the next chapter.

TRADING ON THE EQUITY

The financial plan of the American investment trust is

21 This exceeds the "conservative ratio" of capital assets to common, which he first put at five to one elsewhere (p. 91), in contrast to the "ordinarily approved ratio" of ten to one of deposits to bank capital. Campbell in the Harvard Business Review, April, 1924, p. 297, believes one sixth "probably the lowest amount found expedient." Fowler, p. 41, relates the set-up to the investment policy followed. Holding of a substantial amount of bonds alone justifies a large proportion of bonds and preferred stock.

important for two reasons. From the purely financial point of view, it shows the general degree of soundness of the enterprise. This has just been considered. Equally important, it shows the extent to which the organizers trade on the equity, hence the fairness of the plan to the general public. The investor should understand both phases.

The organizers of a corporate American trust want a direct return for promotional services.[22] As explained in Chapter IV, they therefore trade on the equity. The general public puts up most of the funds at a fixed rate of return, and receives the smaller share of the excess profits representing net income after deducting charges, both fixed and contingent (such as dividends on preferred stock); the managers put up a small part of the funds, and get a large part of the excess profits. The public buys primarily senior, the managers junior securities. Or, if they both buy the same kinds of securities, the managers buy them on more favorable terms than the public.[23] In order to raise the desired funds, the securities offered to the public must be "dressed up" with various seductive appeals to meet the public taste. They must raise the money; but they must give the managers the excess compensation they desire and must not endanger their control. Unless these features be borne in mind, the financial plan can not be understood.

22 The fact that directors and / or officers "agree to serve without compensation," as sometimes stated, means merely that they choose to take their compensation in another form.

23 Rare cases exist in which this is not true. Thus in the American and Scottish Investment Company the common is being sold to public and organizers on the same basis. George M. Forman and Company agree to buy one share of the $25.00 common at par for each share of the original 100,000 sold. This will raise half the authorized common, and presumably public and organizers will then trade on the equity by selling others $5,000,000 of $100.00 par preferred stock, and arrange to dispose of the other half of the common. The only special management compensation is one half of one per cent per annum of the fund. This is in many ways like a fund type trust, rather than a corporate trust.

Robinson to the contrary notwithstanding, this is far more important than, "in introducing investment trust securities to the American public," to lay emphasis "upon the salient features of each type of issue offered," for the very reason that "concentration upon the immediate selling argument prevents other than a very cursory description of the general set-up and functioning of the trust." [24]

Financial plans vary greatly. No standard basis exists, on which public and organizers enter into their partnership.[25] The public, in fact, seems more concerned with the dress which the security wears, than with the financial plan of which it is a part. Some trust managers can therefore force onerous terms on an unsuspecting public; but others have been eminently modest in their exactions. In some cases, the senior securities alone represent the actual investment and the common stock is a pure bonus, but in others the common is actually sold for money. The latter practice, of course, is greatly to be preferred. Most trusts, it may be observed, make their initial senior offering a preferred stock, and reserve their bond issues until later, when the enterprise is more seasoned and can sell them to the public on a lower yield basis, while it itself knows better its own capabilities in handling funds and is better prepared to meet a fixed as distinct from a contingent charge upon income. Successive issues of preferred stock find the new participants joining on a less favorable basis than did those who went before.

In general, the senior security is "jazzed up" for public

24 P. 63.

25 The California supervisory authorities, in their seventh rule, require "that a good and sufficient showing shall be made that those who are initiating the business of an investment trust shall have subscribed and paid in an aggregate amount equal to not less than twenty per cent (20%) of the initial paid-in capital." Their eighth rule forbids issue of securities (or payment of cash) for promotional services or intangible property. Keane, pp. 805–806.

consumption by tying directly to it a participation in excess earnings. This may be accomplished in various ways, which afford a basis for classification of investment trust set-ups. Omitting minor details, of which there are an infinite variety, the following alternatives are found:

1. The public buys a unit of preferred and common stock, while the organizers buy only common and the bulk of that. Instead of, or in addition to units, the preferred may carry common stock purchase warrants, possibly non-detachable, and at a price above the present market.[26]

2. The public buys a participating preferred stock, while the organizers buy all the common. This dispenses with common for the public and substitutes an issue that combines the nature of both preferred and common stock. While the public might buy a convertible preferred stock instead, this rarely suffices in actual practice and does not stand alone.

3. The public buys a unit of first preferred stock and common stock, while the organizers buy all the second preferred stock and the bulk of the common.

4. The public buys bonds in place of the preferred stock mentioned in the preceding plans. The bonds carry bonus or purchase warrants for common stock or else are made convertible. Plans of this type are similar to those under each of the first three headings, but not as popular as those using preferred stock.

5. In addition to preferred, perhaps together with common, the public also buys bonds, perhaps with common attached in some fashion. In other words, to each of the first three plans may be added a bond senior to the pre-

[26] Stock purchase warrants have their drawbacks. They enable the public to play safe, but raise junior capital at a time when not needed and when the trust can better approach the general public with senior securities.

ferred, perhaps only after the trust has been operating for some time. The result is a full fledged so-called British type trust, although the strict analogy exists only where the trust has bonds of equal standing, preferred all of equal standing, and one class of common.[27]

In all these plans, the compensation of the management is determined indirectly. The basis on which the investing public participates is fixed at the outset, and the organizers receive the securities remaining, representing a claim to the earnings left over after deducting charges on the senior securities sold to the public and the public's share of the junior equity. The public is generally not approached in the other fashion, as it was years ago in England, by issuing founders shares or by giving the organizers special options to buy[28] not granted to the public. The plan is made more pleasing to the public—albeit no less effective —by seeming to give the public whatever special position exists.

Lest it be felt that undue criticism is made here of investment trust managers, it must be stated that they have merely carried over the security types developed in other investment banking fields. With a public "educated" to look for business-man investments, and with an American economic and financial system in which the promoter receives high reward if he succeeds, they have merely adapted their methods to the situation by carrying over the devices already proven effective elsewhere. In their financing methods they have not originated new practices, but instead made skillful use of those already existing.

27 See the appendix to this chapter for detailed analyses. Of course, after the trust has become well established, senior securities, especially bonds, can be sold on their investment merit alone, without an added speculative feature.

28 Some of course exist today in the United States, as noted later in the present chapter.

BONDS

The next question which arises is the characteristics of the different classes of securities which investment trusts issue. This includes the forms of each; the devices attached to each to safeguard the investor and to appeal to him; the logic underlying their use, showing both the merits and the weaknesses; and, last, the general extent of use of each. In short, we have here, as in the discussion of the financial plan, applied to one special field, a problem usual in corporate finance, or, viewed with the lender's eyes, in investment. It is, of course, related to the entire trust set-up, since the features appertaining to the securities, as well as the unit or other method of sale, determine the willingness of the public to participate.[29]

Investment trust bond issues are of two classes. Debentures carry no specific security, but are based on the general credit of the issuer. Collateral trust bonds, on the other hand, carry specific security in the way of bonds and stocks held by a trustee for the protection of the bond-holder. Very rarely do British trusts offer other than what they call debenture stock. This is usually secured by trust deed, deed poll or indenture, although some trusts use no special indenture of any kind. But often the debenture stock has a "floating charge," which becomes a fixed charge on assets (prior to general creditors and subsequent debentures) in the event of default on specified covenants contained in the indenture.[30] By issuing debenture stock, British trusts avoid using the clumsy collateral trust

[29] Conversion provisions are omitted here, since their significance is apparent only in a study of the entire set-up.

[30] About half the British trusts therefore nominate "debenture stock trustees," and in the event of insolvency the receiver for the debenture owners holds the assets of the trust as against less favored creditors. Robinson, p. 50.

bond, which is inconvenient when the trust turns over its portfolio and adds to cost by the clerical and other labor necessary in holding and overseeing the collateral. Therefore the collateral trust note is also rare in the United States. In fact, the International Securities Corporation has abandoned the device in favor of debenture borrowing and, as investment trusts have become better known, they have experienced no difficulty in raising funds by debenture borrowings. Only on the Pacific Coast has the collateral trust bond continued to be popular.

British trusts issue both perpetual and terminable debentures. Many availed themselves of the low money rates of the nineties and the first decade of the present century to borrow without redemption date. Despite moderate earnings on total portfolio, the small fixed charges have contributed to a handsome yield on the common—much, it may be added, to the subsequent disgust of the bondholders who further saw the market value of their principal decline as market rates of interest advanced. A few perpetual debentures are redeemable at the option of the trust. Terminable debentures, that is, bonds of fixed maturity, are also frequent. In the United States, such bonds are universal. Maturity selected, in fact, depends upon present and anticipated future market rates of interest, many trusts having several series issued at different times with different maturity dates and interest rates. Thus some Scottish trusts in recent years have favored short dated debentures. They appeal to cautious investors, as well as to trustees who have to turn their funds over when the beneficiary attains his majority. They may also enable the trust to refund under more favorable conditions, if market rates are relatively high when funds are first needed. Actual American maturities range from five to twenty-five years, with twenty years most common. Frequently the American trust makes its bonds callable. In such cases, a scale is generally set, with a small initial premium, such as two to three per cent, which tapers off by one or more steps to par when more or less close to maturity.

Rates that British obligations carry range from three and one-half to five per cent, with four per cent usual. Several years ago the Scottish trusts could raise funds at slightly under five per cent, while the average yield for debentures of large British trusts was around five and one-fourth per cent. The low yield on these obligations reflects their investment character, and insurance companies are large holders of these securities. American trusts have by no means faced a period of such low interest rates as have British trusts. Five per cent is the prevailing American coupon rate, with four and one-half rare and a few cases of five and one-half and six per cent, the latter chiefly for earlier issues or smaller trusts.

In order to protect the less well known American debentures—partly because of the thinness of the equity behind them, especially as contrasted with British trusts—some American trusts introduce an asset provision which will avoid further dilution of the equity. In most issues in which the bondholder is given a tonic in the form of common stock participation, the restriction takes some such form as forbidding issue of additional obligations of equal position unless the book value of trust assets is at least a specified percentage, generally one hundred twenty to one hundred forty per cent, of the amount of both existing and proposed issues. In some cases it further forbids distribution of assets, whether by way of dividend payment, stock redemption or other means, below that figure. In each case, the margin of junior funds is rather slender.

When the bonds are to be sold on their own merits as investments, and not "jazzed up," the provisions are more stringent. For example, the International's present debenture issue has the following protection:

1. No additional debt other than debentures may be issued.

2. Additional debentures may be issued only when current assets equal two hundred per cent of entire funded debt then to be outstanding (in other words, not over fifty per cent of the total capital may be represented by bonds).

3. In event of mortgage or pledge of assets, except to secure temporary indebtedness, the trust will secure the debentures equally and ratably.

4. If current assets decline below one hundred twenty-five per cent of funded and current debt, and remain below for sixty days after notice to the trust, the trustee may declare the debentures due and payable upon request to it by holders of thirty per cent of the debentures.

The Second International requirements are the same, with the added proviso that no temporary indebtedness (secured or unsecured) can be created if total temporary indebtedness would then exceed two hundred per cent of current resources plus fair market value of collateral pledged for temporary indebtedness.

Somewhat similar provisions obtain in the case of The Investment Company of America and the Pacific Investing Corporation, which sold their debentures with warrants, substituting the following limitations upon temporary indebtedness:

1. Shall not exceed fifteen per cent of trust's current resources.

2. Shall not exceed sixty-five per cent of trust's current resources, when debentures are added to such indebtedness.

3. No pledge or mortgage of assets for temporary indebtedness shall reduce unpledged assets below one hundred

fifty per cent of total unsecured indebtedness, including debentures.

American collateral trust bonds, of course, contain specific provisions as to nature and maintenance of the collateral, important in view of the necessity of substituting collateral as securities are sold. The original International bonds under their indenture as amended provided threefold asset protection:

1. Market value of underlying collateral must be maintained at a minimum of one hundred fifteen per cent of par value of outstanding bonds, under pain of default. The trustee only authenticates additional bonds when it has actual possession of the collateral.

2. When $1,000,000 or more bonds are outstanding, not over one-fourth of one per cent of the collateral shall be in any one security.

3. Assets of the trust (cash and securities at net cost) must be one hundred and eighty per cent of outstanding obligations before additional obligations can be issued.

Some others use instead one hundred twenty to one hundred thirty per cent in the first restriction, require the securities to be listed on specified exchanges, not over two to five or ten per cent in one security nor, in one trust, thirty-three and one third per cent in one class of security. Some indentures permit removal of the trustee by holders of a majority of the debentures and selection by them of the successor trustee.

OTHER FORMS OF BORROWING

Short term loans from the general public were used by a few British trusts several years ago. The maturity was six months to one year, the rate three-fourths to one per cent above the bank rate. Deposits are also accepted, payable on one month or even one week's notice and bearing interest at about one-half per cent above the bank rate. A few well established trusts have at times obtained as much as several hundred thousand pounds in this manner, which they employed in short-term investments. Especially were such operations marked when British Treasury bills were selling to yield more than six per cent. In the United States, deposits can only be received by institutions organized under the banking laws, and any such operations are merely auxiliary to the main activities of the trusts.

Bank borrowing is generally opposed, especially if the trust has considerable funded debt outstanding. Investment trust assets are of distant maturity, and liquidation at any arbitrary time may involve loss. The cost of such borrowing, too, varies greatly over a period of time. In favor of this form of borrowing, is the fact that rates are generally much less than on bonds and the cost of obtaining the advance is slight as contrasted with the expense of marketing securities, while the sum is flexible and may be adjusted to the trust's needs. Nevertheless such capital is generally favored only for temporary purposes: either to anticipate a bond or note flotation shortly to be made, or in place of such borrowing pending more favorable market conditions.

Both British and American trusts generally reserve the right to borrow on short term. The former commonly limit such borrowing to temporary purposes and to an amount not to exceed ten per cent or twenty per cent of capital and reserves. Since the war, their borrowing in this fashion has been less frequent. American trusts generally do not limit current borrowing.[31] Some of them

31 Some indication of their attitude is given in the debenture covenants cited in the last section and in the preferred stock covenants cited in the next section. The California authorities in their thirteenth

have been relatively heavy borrowers, but in general they have been smaller or newer trusts which have had no bonds outstanding. By no means have they borrowed to the same extent as other trusts which have relied upon bonds instead, although in rare cases the bank loans exceed the share capital somewhat.[32] The Financial Investing Company of New York, Ltd., which is engaged in expansion, apparently relies continually, however, upon bank loans to supplement outstanding bonds, its April 30, 1928 balance sheet showing bonds of $1,562,000 and loans of $573,000, as compared with shareholders' equity from all sources of $1,454,000.

Trading on margin may be regarded as a substitute for bank borrowing. British trusts, however, condemn it strongly, perhaps because of the attitude towards investment operations which it induces. So does the Attorney General of the State of New York.[33] On the other hand, the Stanford University study regards buying on a very conservative margin as a substitute in many instances for borrowing by means of bonds. This view reflects, of course, the American attitude towards turnover of investments, although the practice presents the danger of making manipulation by insiders easier. In general, however, the amounts shown in the balance sheets of American trusts have been very small, due to prevailing investment conditions. In fact, the balance sheets at the close of 1927 tended to show call loans as an asset rather than as a liability item.

rule limit temporary indebtedness to 50% of current assets and limit it to a period "consistent with good business." Keane, p. 806.

[32] For example, Bankstocks Corporation of Maryland on December 31, 1927, showed secured notes payable of $1,121,000 and secured brokers account of $187,000, as compared with preferred and common shareholders equity of $1,114,000.

[33] Survey, p. 79.

PREFERRED STOCK

Unlike the British, American trust shares have no standard denomination. Some have par value, others evidently feel the preferred fits into the balance sheet more neatly if a par be eliminated. In such cases, of course, the dissolution figure provides a substitute. Par value fixed by trusts sponsored by leading houses is usually one hundred dollars, while twenty-five and fifty dollars is also not infrequent. The American trusts, again unlike the British, do not leave their shares part paid. In the interest of flexibility, American shares, further unlike British,[34] usually are made redeemable at the issuer's option. The figure set is either par, or a moderate premium larger than the bond premium. It ranges in general from about two and one half to twenty-five per cent, varying and tending to decrease in some older trusts with successive series. Rarely is the preferred redeemable at say one hundred five before 1930 or 1933 and one hundred two or one hundred two and one-half thereafter. Five per cent and ten per cent are today most common.

Preferred stock is generally preferred both as to assets and earnings, and cumulative. British dividend rates generally vary from four to five and one-half per cent. Each company paying four to four and one-half per cent was organized by the mid-nineties, and the tendency is noticeable to pay higher rates since 1900. Five per cent is usual, while six per cent is rare, although some financing companies pay this sum. Numerous trusts have several series of preferred outstanding, bearing different rates and marketed at different times. Where participation in earnings is given, as it is infrequently, it is severely limited.

34 This has been contrary for many years to Company law.

A typical provision sets the minimum rate at four per cent, and under given circumstances [35] permits further participation, not to exceed five per cent in all.

American rates are distinctly higher, since the trusts have not been well established nor have they faced a low money rate period. They pay quarterly or semi-annually. Rates vary from four and one-half to eight per cent, with six per cent most frequent, but seven per cent is paid in some prominent cases. In general, it may be said, the rate is some one per cent greater than that carried by the bonds. Several older trusts with several series show a declining tendency. The second preferred usually carries no higher rate than the first. Since it is sold as an investment, the preferred dividend is cumulative. Conversion and participation provisions are discussed in connection with the entire financial plan.[36]

The preferred stock of American trusts—and bonds, it may be added, as well—give quite a high yield. Aside from the factors just mentioned, this may be ascribed both to structure (including the possibility of additional issues of equal or senior position) and to the speculative character of the whole movement. The spread between bid and asked prices is great and the market thin. At the same time, these high rates create quite a serious investment problem. If the cost of capital to the trust exceeds—as it so often does—the rates of current return on securities the trust can place in its portfolio, and opportunities for turnover profits should become increasingly scant, the trust would seem to lose one of the pillars on which it is reared.

In view of the method of issue, preference stock of

[35] For example, after eight per cent is paid on the deferred, excess earnings are divided equally.

[36] An extremely rare provision, reminiscent of British models, is that which gives the preference stock of Sterling Securities Corporation five and one half per cent cumulative dividends, plus one half of one per cent noncumulative if earned.

British trusts frequently carries voting rights. A common provision is to give every member one vote per share, and when the shares are converted into preference and ordinary, to give one vote per ten pound preference share and four votes per ten pound ordinary share. In the United States the trusts generally grant the preferred no regular voting power, but often grant it under certain circumstances, such as default of dividends for one to two years, or in some such cases they permit the preferred to select a majority of the board or possess exclusive voting power.

Some British trusts issue what is in effect a noncumulative second preferred stock. The ordinary stock is divided into preferred ordinary and deferred ordinary, the former carrying a noncumulative fixed rate of dividend greater than that found on the preference shares, to which it is entitled before dividends are declared on the deferred ordinary, and also a preference as to assets junior to the preference but senior to the deferred ordinary. American trusts in some cases issue two classes of preferred stock, perhaps giving the second preferred the name of A stock as distinct from preferred.

Special protective clauses are found in some American trusts, the reason being similar to that existing in the case of bonds and the provision similar but less stringent. They relate to maintenance of assets values (that is, equity junior to the preferred) and less often maintenance of a dividend reserve. Usually it is merely provided that no additional preferred of equal position can be issued unless the book value of the preferred is at least a specified percentage of its par, generally one hundred twenty-five to one hundred fifty per cent, less often one hundred fifteen to one hundred and twenty per cent. In a few cases, it is further provided that no distribution of assets, whether by way of payment of dividends, redemption of a junior preferred or other means, may be made below that figure. The International, instead, requires that cost of net assets (less debt and preferred share dividend reserve) equal one hundred thirty-three per cent of par value of outstanding and proposed preferred, one hundred twenty-five per cent when taken at market value. The Federated Capital Corporation builds up a reserve equal, together with paid-up capital, surplus and reserves, to three times the preferred stock outstanding, by setting aside profits remaining after paying at the rate of twenty per cent per annum on the common. Several trusts require a two-thirds vote of all preferred then outstanding before a new class of stock with priority to it can be created.

A dividend reserve is about as frequent as an asset provision. It requires building up of a fund by setting aside, for example in the American Founders Trust, ten per cent of net earnings remaining after the preferred dividend, until the fund equals ten times the annual dividend requirements on that issue, and maintenance thereafter at that figure. On its second preferred, that trust halves the figures in relation to the second preferred issue. In its revised plan, the Standard International Securities Corporation proposes to set aside all realized capital gains to an "investment and preferred stock dividend reserve," until the latter equals three times annual preferred dividend requirements.

COMMON AND MANAGEMENT STOCK

Common shares are much the same as in a regular business corporation. The British trusts invariably have par value, but many of the American do not, for the same reason of flexibility—necessary because of the thin equity

—that obtains in the case of the preferred, but in even greater degree. Where par value obtains, it is likely to be small—ten, twenty-five or at most fifty dollars—rather than one hundred dollars. At times the units of preferred and common are put in the form of allotment certificates, rather than disassociated. The common generally has voting control,[37] but the organizers usually see that their own domination is perpetuated when they devise the financial plan. American trusts rarely issue stock part paid.

Some trusts have two classes of common—A and B. Often the larger, held by the public, does not vote, while the smaller, held by the managers, has sole voting power. The use of A and B shares often gives rise to curious hybrid securities. The International group of trusts favor dividing the no par common into two classes—an A owned by the public, a B owned by the American Founders Trust, the management organization. Both vote, subject to the rights of the preferred in event of default, and both participate in distribution of assets. But the public's A gets priority as to non-cumulative dividends, in the Second International Securities Corporation according to the following schedule:

First, up to $2.50 per share on class A common
Second, up to $1.50 per share on class B common
Third, an additional $1.50 per share on class A common—total $4.00
Fourth, an additional $2.50 per share on class B common—total $4.00

Thereafter, additional dividends are paid equally on both classes. The managers' B shares, whenever surplus and / or reserves of the trust equal $10,000,000, and dividends

[37] A conspicuous exception is The Investment Company of America, where the peculiar legal form makes the trustees independent of any investor control.

at the rate of four dollars per share have been paid on both class A and class B for two years, are convertible into an equal amount of class A shares. In other words, the public's common preferences fall away, at the managers' option, after a certain record of success has been achieved.[38] This is of course far different than the mere non-voting A common sometimes sold the public and voting B sold the organizers.

Special management or founders shares meet with little favor today. Only nineteen of Lee's one hundred thirty-three British companies have had some form of such participating or special "deferred" shares at some time in their history, and ten of these converted or cancelled all such shares, frequently at considerable cost.[39] Less than one-tenth of one per cent of the present outstanding share capital of the one hundred thirty-three trusts is represented by participating shares and some two-thirds of this is for two small trusts and one which engages in financing also. It is regarded as a holdover from earlier times when directors received no compensation other than the privilege of participating in profits after the concern had reached a paying stage, but has recurred in some recent small trusts. Ordinary and preference shareholders evidence a growing and widespread resentment against what they consider the unfair distribution of profits resulting to the holders of such shares, since the founders pay in only a small sum for the few shares issued, which may enjoy a considerable "break" in excess profits. To illustrate the possibilities, one British company has paid dividends from 1922–1927 on its ordinary stock of from seven and one-third per cent to seven and three-fourths per cent, and dividends on the

38 In the International and Second International there is a similar feature with respect to the first preferred sold the public and the second preferred held by the American Founders Trust.

39 Pp. 9–10.

founders shares of from 44–1/6 to 113.95 per cent, averaging some 79.6 per cent.

A few American trusts, however, use the founders share device. Continental Shares, Inc. has ten thousand founders shares, all held by the organizers, who also hold substantial amounts of common, the remainder of which was sold to the public, as was the sixty thousand shares of preferred, partly with common stock purchase warrants. These founders shares do not vote and receive only twenty-five per cent of the excess profits after four dollars has been paid (since organization) on the common, as well as a similar participation in liquidation after the no par common receives fifty dollars per share. The use of such special shares, as already pointed out, has a bad psychological reaction, and the organizers can achieve the same object when drawing up the financial plan much more gracefully and without resistance from the public.

MARKETING TRUST SECURITIES

Raising of British investment trust capital has become fairly well standardized. Many British trust groups have sponsored new trusts in recent years, while others have been formed by men more or less known in the financial world. When publicly offered, a substantial proportion (often sixty per cent) is placed at par through directors and their brokers, the latter frequently receiving a lump sum by way of compensation for their services. New issues of existing trusts usually need not be underwritten, and many issues of new trusts, due to the eagerness of the public to absorb such securities. The underwriting fee as a rule does not exceed one and one-half per cent, with sometimes on overriding commission of one-half per cent. The common practice is to allow brokers a commission of one-fourth per cent (or a stated amount ranging from three d. to one s. per share.) on applications bearing their stamp. Brokers occasionally receive one-half per cent or one per cent for handling a block of debentures, part of which goes to agencies assisting in marketing. Such expense is additional, of course, to governmental charges. Shares are never issued at less than par and often instead at a premium sufficient to cover the entire issue and marketing cost.

American methods of security distribution differ greatly from the British. Those trusts which appeal only to friends and associates of the organizers can, if they so desire, keep down the expense of raising funds. But those which approach the general public face a different situation. First, they face the problem, either of selling directly at retail to the public, or of using established banking channels. Here the choice is but little different from that which the ordinary corporation faces. Established bankers, it is generally felt, give a far more satisfactory distribution, and a less costly one, too. It is probably true that direct retailing prevails only where established bankers, due to the lack of appeal of the directorate and management and / or the lack of junior capital to be supplied by them, hesitate to "take on" the distribution, or else where salesmen sponsor the new trust.

The ideal method would seem to be, to have an established house underwrite an issue and distribute it with houses that it selected. This method of a round sum issue at a stated time is general in Great Britain; and it is becoming increasingly used in the United States. But in the early years, continuous selling was employed by corporate trusts. The securities were kept on tap and fed to the public in response to demand—a practice which fund, fixed and managed list trusts today generally follow. For a newly organized trust it may be advantageous to bring the capital in by degrees, provided the funds come as the trust wishes them, instead of merely as the public fancy dictates or perhaps not at all, while for a well established trust occasional issues are certainly more satisfactory. The chief reason for tap sales was probably the necessity of building up a marketing system outside the larger investment banking channels, who did not know the business and wished to see first how it developed. Such continuous sales forced the trust to build up a dealer organization, with wholesale men and considerable literature and advertising. For a rapidly growing group like the International, the dealers acquired in the early years have proven helpful in the process of expansion. It now uses only occasional issues, instead of continuous ones, but these dealers have assisted—continuously—in redistributing the stock which the American Founders Trust bought in the process of maintaining a market.[40] While these dealers handle stock, the bond issues of the trusts have for some time been put out through Harris, Forbes & Co.

English trust securities are usually listed on the London Stock Exchange. No American trust securities, however, are listed on the New York Stock Exchange, which has informally set its face against listing any such issues; a few are listed in Boston, on the New York Curb, or in local centers, such as Baltimore, partly by the trust themselves, partly at the instance of security dealers. Most are traded in only over the counter, and a considerable market exists in New York. Marketability of trust securities seems wide enough, so that little agitation for listing exists, according to the Attorney General of the State of New York,[41] for the same reason that banks and insurance companies prefer an over the counter market. The spread between bid and

[40] In its last annual report, the American Founders Trust stated that it does not maintain a market for its own securities.

[41] Survey, p. 94.

asked prices, as reported in a newspaper like the New York Times, differs greatly for the same priced shares. In less active trust securities, the quotations are apt to be nominal and the market thin. A limited market, of course, lends itself easily to manipulation.

At least in the initial stages of a trust's career, the task of maintaining the market devolves upon the trust sponsors, whose bid price sets the basis for dealer quotations. Some older trusts were able to discontinue market support; in fact, they were desirous of keeping quotations down within reason during the great upward surge some time ago, rather than to hold them up. But with the drop in general security prices complaint has arisen that trust sponsors recognize little responsibility towards the general public in the way of maintaining a market. They either refuse to make a bid at all or else name a very low figure. As a result, market prices for some important trusts "melted away" and the market tended to vanish as regular dealers have found the backlog of support withdrawn.

SOME CRITICISMS—DISTRIBUTIVE COSTS

There is no doubt that some abuses have crept into investment trust security merchandising, just as they do into any other new field. The public and the dealers have been unfamiliar with the issues and some exaggeration in presenting the new institution in the guise of a magic "get rich quick" device was inevitable. High pressure methods by salesmen of lesser known trusts who approached the general public direct have of course occurred, yet probably no worse than in other fields. And there has been no agreement as to just how much data ought to go into the circular and other literature, so that analysis of the exact basis of participation between organizers and public often remains undisclosed. Yet, except for the initiated investor, such information is often of little value because it is not understood. A full frank statement is highly desirable, but also an educated investor who knows what it means.

The chief objection, however, lies along the line of cost. A security house, laying the issue down with those of its clients who vest discretion in it, can afford to distribute the security very cheaply. At the opposite pole, an investment trust building up its own retail or dealer organization must incur heavy expense. The more widespread the circle of investors reached, the more the small investor is enlisted, the greater the cost becomes. Thus actual costs of raising capital vary greatly. The Attorney General of the State of New York [42] showed the following figures for a few trusts, none of which had the benefit of a large investment banking house's services:

Name	*Percentage*
International Securities Corporation	5%
Second International Securities Corporation	4%
American Founders Trust	5½%
Financial Investing Co. of New York, Ltd.	6¾%
Bankstocks Corporation of Maryland	10%
First Investment Company (New Hampshire)	10%
Bankers Securities Trust	20%

He concluded that 10% is sufficient.[43]

This figure will no doubt seem excessive to many. Yet, considering the character of the security, it is in harmony with the general scale of charges in American security distribution. Whatever criticism is leveled at it, must be

42 Pp. 62–63. For average investor's holding in various trusts, see Fowler, p. 30.

43 The California authorities have embodied such a limitation in their tenth rule. Keane, p. 806.

leveled at the entire system whereby securities are distributed in this country. To search out the individual investor and place the opportunity of sharing in an investment trust within his reach, entails a heavy payment by him for the privilege offered. Whether these costs can be reduced, and how, has often been discussed and falls beyond the scope of this work. Whether we cannot come closer to British practice, remains to be seen. Suffice it to say here that those trusts offering the investor the securities subject to only a small distributive cost—whether they be corporate or fund type trusts (described in Chapter VIII)—have relied upon personal contact with investors, plus the scattering interest that publicity of a general sort may arouse. And all this discussion of security distribution costs tells nothing of the return which the organizers—and bankers coöperating with them—may obtain through trading on the equity. Technically a return for promotive service and management ability, in a successful trust it will far overshadow the profit made on initial distribution of the securities and make the latter seem relatively small.

TRUST SPONSORSHIP

British trusts formed in recent years have been organized largely by existing trusts, but also by men heretofore outside the field, who are familiar with a given industry.[44] American trusts have been largely organized by four different classes:[45]

1. Groups of professional investment trust managers whose interests center entirely in this field. The chief is the American Founders Trust and its associated investment trusts—the International Securities Corporation, the

[44] See Chapter II, p. 36.
[45] Attorney General of the State of New York, Survey, pp. 9–18. See Chapter III, p. 62.

Second International Securities Corporation and the United States and British International Securities Corporation. Several other trusts have been formed—as the beginning of a group in each case—by men formerly connected with the International group, for example, the Financial Investing Company of New York, Ltd., the Standard International Securities Corporation and the Atlantic & Pacific International Corporation.

2. Firms of investment consultants and professional trustees (largely in Boston), who operate investment trusts in addition to their investment advisory work. But their affiliations have been largely with the fund type trusts discussed in Chapter VIII.

3. Investment banking houses, which have organized investment trusts, either singly or in coöperation with other houses. Thus Dillon Read & Co. (United States & Foreign Securities Corp.), Kidder Peabody & Co. (Kidder Participations, Inc.), A. G. Becker & Co. (Domestic & Foreign Investors Corporation), and John Nickerson & Co. (Guardian Investors Corporation), come to mind in the former group. Among trusts formed by coöperating houses are General American Investors Co., Inc., by Lehman Bros. & Lazard Freres; Standard Investing Corporation, by Brown Bros. and Stone & Webster & Blodget, Inc., and Continental Securities Corporation, by Brown Bros., Lee Higginson & Co., J. Henry Schroder Banking Corporation and Clark, Dodge and Company. Nor have local investment banking houses been neglectful of the opportunities.

4. Banks and trust companies and their associated securities companies. Often these form general investment trusts, for example, the National Shawmut Bank and the Old Colony Trust Company. But often they or their officials form bank holding companies (discussed in Chap-

ter XI), such as the City Financial Corporation or Hub Financial Corporation, formed respectively through the Bank of United States and the Seventh National Bank of New York.

Some trusts which have had the task of building up their own dealer organizations for purposes of distribution, instead of leaving the task to an established banking house, have tried to enlist dealer interest by holding out to them the idea of participating in trust profits by owning some of the junior securities, either of the trust itself or of the management company which controls the trust. The associated dealers, in coöperation with the organizers, trade on the equity against the public and the trust becomes a cooperative undertaking from the dealer—though not from the investor—point of view. In this way, it is hoped to obtain better dealers and "tie" them into the trust. Two organizations which have developed this idea are the Standard International Securities Corporation, in its revised plan, and the Founders Securities Trust with its affiliated investment trust, the United Investment Assurance Trust.[46]

Two questions arise. First is that of group management and concentration of control. The advantage of a single managerial organization, spreading the overhead over a number of trusts, is manifest. Many trusts have frankly avowed this object, but relatively few have as yet achieved it. Young as the American movement is, some concentration of control is evident, but only for the more important trusts. Interlocking directorates seem a great means towards this end.

Second is the now hotly debated question of the relation which should exist between investment trusts and security houses. Many praise the British ideal of maintenance of an

[46] See the booklet of Seager, C. W., A Banker's Message to the Investment Dealer, published by the Founders Securities Trust in 1927, pp. 79.

independent investment position, uninfluenced by outside consideration, but it is true that the directors who make that possible are capitalists of substance with wide ramifications in their contacts.[47] Again, the high minded investment banking house can offer its trust certain investment opportunities at first hand and on favorable terms. Against this is to be set the danger that the house is more important than the trust, hence the latter may be made a resting place for slow moving issues or used to provide a fund for house operations.[48] Existing reports of holdings of trusts may be interpreted to lend strength to either contention. The United States and Foreign Securities Corporation undoubtedly provided a convenient berth or parking place for Dodge stock,[49] but it acquired the stock on a better basis than did the public. From the point of view of raising trust capital, as distinct from the investment phase, the security house sponsorship undoubtedly provides a convenient and cheaper source of funds.

THE BRITISH COÖPERATIVE TRUSTS

In England several companies formed under the Industrial and Provident Societies Acts (which are used by every coöperative society), instead of under the Companies Acts, have attracted much attention. The First Co-

[47] Morrison, P. L., The Investment Trust, published by Geo. M. Forman & Co.

[48] Several trusts therefore forbid sale to the trust at a profit and in a few cases even of securities which have reposed on the dealer's shelves more than a certain time. The California authorities' sixth rule forbids officers, directors, trustees and / or managers to deal with themselves or with companies in which they are principals in the investment of funds, as well as to profit, directly or indirectly, by virtue of dealing with the trust. Keane, p. 805.

[49] In the spring of 1926, Dillon, Read and Co. purchased the Dodge automobile business from the estate of the former owners for $146,000,000, and proceeded to refinance themselves by incorporating a new company and selling all the senior securities thereof to the public.

operative Investment Trust, Ltd., was organized in 1924, the Second in the same year, the Third in 1927, and the Fourth in 1928, all having the same directorate. The organizers were a group of men having both labor and investment contacts and experience, and in sympathy with the coöperative movement. Within the last couple of years several small trusts have frankly been patterned after them—one, for example, to dispose of funds of philanthropic institutions, another on behalf of several employers for use by their workers.

The investment aims and methods of the coöperative group of trusts do not differ from those of the old line trusts. But they aim at rendering a wider service and at rendering it to the small man. They offer their members use of a library, a monthly publication, advice on investment holdings, etc. Their chief difference, however, lies in the raising of capital. They have one class of shares, not two.[50] They approach the small man, selling him 2 s. shares (the usual trust denomination is £10), at an entrance fee or premium of from 1 d. to 3 d. per share, corresponding to the enhancement in the trust's principal. Under the law, no one may hold more than £200 of its shares (2,000 shares), but this is not a great handicap, since the limit applies to each trust separately and each member of a family sixteen years of age or more, can hold shares. The minimum holding is ten shares or £1. These shares it sells continuously, and all over the world, especially in the British colonies. The minority are sold through agents who receive 2½%, the majority as a result of advertising and the experience of satisfied holders who have extended their participation and told their friends. In part the appeal is

[50] Efforts are being made to list the shares on the London Stock Exchange. A sort of preference share has also recently been proposed —£5 denomination, without entrance fee, paying 5½% if held over six months and 5% if held less than six months.

due to the fact that the income from these shares, unlike other trusts, is exempt from the British income tax and the trust need not deduct a tax. The trusts have auditors appointed by His Majesty's Commissioners of the Treasury. The directors receive a percentage of actual dividends paid unless these are 5% or less, when they receive nothing. The trust makes a market at 2 s. per share, and lends the full nominal value to members, who forego dividends during the term of the loan.

The first two coöperative trusts have shown extraordinary growth, especially of late. Fom the beginning they have paid dividends altho during the six months ended July 31, 1928 the first failed to earn its dividend by a small margin. Their record of growth is as follows:

	FIRST			*SECOND*		
Date	Members	Capital	Reserve and Carry Forward	Members	Capital	Reserve and Carry Forward
Jan. 31, 1925	563	£28,691	£1,458	19	£1,716	£65
Jan. 31, 1926	3,924	215,141	10,869	180	17,296	1,738
Jan. 31, 1927	10,598	626,379	28,333	581	56,286	3,331
Sept. 30, 1927				10,536	293,658	4,722
Jan. 31, 1928	18,322	1,262,845	69,008			

As the size of the fund increased, the number of securities held likewise increased, from 62 to 570 and from 11 to 290, respectively.

The question has often been raised, would not coöperative trusts be desirable for the United States? These trusts—and the same is true of all British trusts—eliminate the trading on the equity by the organizers for which American corporate trusts have been renowned. They have an advantage over the regular British trust—neglecting the practically potent feature of taxation—in their appeal to the small man; and, furthermore, until the recent wave of trust formation, it was difficult to participate at all in a well sponsored British trust. The organizations in the

United States that came closest to the British trust are of the fund type, described in Chapter VIII. The trust sponsored by the Amalgamated Bank of New York is small in size, possibly because any labor bank tends naturally to have offered to it savings rather than commercial deposit accounts. The Investment Managers Company, on its part, raises its funds at least as cheaply as the British coöperatives. But—disregarding differences of investment policy—after several years it has definitely set $10,000 as the minimum participation it will receive.[51]

SELECTED REFERENCES

Fowler, pp. 23–31; Ch. III. Statutory Trusts, pp. 38–52; pp. 53–65; Ch. XV. Promotion Policies, pp. 194–211.

Grayson, Chapter XII, American Methods of Legal Organization, pp. 152–160; pp. 39–51, 58–64, 161–173, 216–217.

Robinson, Chapter II, Legal Status of American Investment Trusts, pp. 18–35; Chapter III, The Structure of Investment Trust Capital, pp. 36–58; Chapter IV, The Raising of Investment Trust Capital, pp. 59–79; pp. 290–298.

Speaker, Chapter II, Characteristic Features of British Investment Trust Organization, pp. 23–36.

Williams, Chapter II, British Trusts, pp. 8–18; pp. 19–23; Chapter VIII, General Management Type, pp. 61–69.

Attorney General of the State of New York, Survey, pp. 19–23; 57–60.

Lee, F. E., Participating Shares in British Investment Trusts. Trade Information Bulletin No. 530, U. S. Dept. of Commerce, Bureau of Foreign & Domestic Commerce, 1928, pp. 1–17.

Valuable for Chapters VI and VII also:

Campbell, E. M. Some Management Problems of Investment Trusts. Harvard Business Review, April, 1924, pp. 296–302.

Einzig, P. Investment Trusts in Great Britain, Bankers Magazine, Feb., 1925, pp. 227–234.

The (London) Financial Times, Annual statistical surveys.

[51] In its accumulative fund, where it pays no dividends, but reinvests income, $1,000.

Lyall, H. J. Criteria of Investment Trusts, Barron's, Aug. 29, 1927.

Robinson, L. R. British Investment Trusts. Supplement to Commerce Reports, April 16, 1923. Trade Information Bulletin No. 88. Finance & Investment Division, pp. 34.

——, A Study of Investment Trusts, Including a Brief Discussion of the International Securities Trust of America, pp. 14.

——, The Investment Trust. The Culmination of Investment Service, 1926, pp. 22.

——, Pioneering in the American Investment Trust Field, Bankers Magazine, June, 1926, pp. 809 ff.

Sawin, M. E. British Investment Trusts. The Street, March 29, 1920.

Tyng, F. E. Jr., Investment Trusts. Alexander Hamilton Institute, Modern Business, Report No. 4, 1920, pp. 31.

APPENDIX TO CHAPTER V

AMERICAN TRUST PLANS

Analysis of plans is by no means simple. Often the financing has been done on several occasions. Too often, the trusts do not disclose the exact terms on which the management participated, stating merely that it holds a substantial proportion of the trust's securities or using a similar unenlightening expression. Attention is therefore concentrated largely in this appendix upon those trusts for which full information of this kind can be obtained, as well as data dealing with the general structure of the trust, unless the latter presents features of special interest. When the trusts have become more stabilized and have had a longer history, it will be possible to test the financial plan by the earnings record. The figures used are in some cases necessarily approximate rather than actual.

PREFERRED AND COMMON UNIT PLANS

The Morristown Securities Corporation represents a clear cut plan of the first type, in which the trust sells the public units of preferred and common and the management common only. It was formed in 1925 by a number of New York capitalists who invited their friends and associates to participate. The set-up was as follows:

	Authorized	Outstanding Dec. 31, 1927
Preferred (5 %, par $100, cumulative non voting, callable at par)	$2,500,000	$1,677,400
Common (no par, voting)	75,000 shares	58,548 shares

The preferred was offered in units of one share preferred and two common at prices ranging from \$120 to \$150 a unit, or \$10 to \$25 for the common. Evidently the organizers obtained a block of 25,000 shares of common at \$10 per share, aside from whatever units they as individuals chose to buy. As organizers, therefore, when the financing is completed, they will have put up only \$250,000 of the total capital of more than \$3,250,000—that is, not over one-thirteenth—and receive one-third the net profits. This is of course rather a good sized trading on the equity. From the purely financial point of view, the plan provides a fair common stock equity back of the preferred, perhaps as much as one-half, certainly one-third.

The set-up of the American Founders Trust had apparently been constructed previously in the same mold. Organized in 1922, it is a management organization for the International group of trusts, which provides investment service to them but also holds substantial amounts of their junior shares as well as of other securities. Its structure is as follows:

	Authorized	Outstanding Nov. 30, 1927 As adjusted
First preferred stock (5½–7%, par \$50, cumulative, callable at 52½, 55 and 57½)	\$15,000,000	\$14,743,550
Second preferred [52] (6%, par \$25, cumulative, callable at \$27.50)	\$2,000,000	\$203,325
Common, no par, voting	33,600,000 shares	749,597 shares [53]

To all practical intents and purposes, the second preferred is negligible. The first preferred has been sold in units. In January 1927, for example, 60,000 units of one share of preferred and one of common were offered at \$82 per unit. Rights have been issued to stockholders on occasion, for instance, to buy units of preferred and common, and stock dividends declared, so that the extent of trading on the equity is obscured. A substantial surplus today exists, almost equal on the books to the value set for the common, and the combined total of both, or book value of the common, exceeds the preferred outstanding. In part this heavier equity reflects the fact cited above that the organization is not a true investment trust.

Somewhat different is the picture presented by the Feder-

[52] Both protected by dividend reserves; vote only in event of four quarterly defaults.

[53] And scrip representing 1,571 shares.

ated Capital Corporation, organized in 1927 as the Federal Investment Trust, Inc. Its set-up appears simple:

	Authorized	Outstanding Jan. 31, 1928
Preferred 6%, par $25, cumulative, voting, callable at $27.50	$8,000,000	$2,109,775
Common, par $10, voting	200,000 shares	32,522 shares

In addition, warrants are outstanding with 83,853 of the 84,391 shares of preferred stock, entitling holders to subscribe for one share of common for every five shares of such preferred at $25 per share. The preferred was first offered at par with common stock purchase warrants, then in units of five shares of preferred and two of common at $186 per unit, and again with common stock purchase warrants at the same rate as before. After March 15, 1928 straight units of preferred and common were sold, use of warrants being discontinued. Evidently part of the common now outstanding was purchased by the organizers, the remainder being purchased by the public in acquiring units. To what extent, is not disclosed, since the amount of preferred sold only with warrants and the amount sold in units with common is unknown, hence the extent to which the organizers traded on the equity is uncertain. It can only be observed that their capital contribution is evidently small. From the purely financial point of view, the book value behind the preferred is fair, due to the policy of selling the common at a premium. The balance sheet as of January 31, 1928 shows common stock and paid-in capital surplus over one-third the preferred.

More complex is the plan of the Bankstocks Corporation of Maryland, organized in 1925. The capitalization is as follows:

	Authorized	Outstanding as adjusted
Preferred 6½% cumulative, par $50, callable at $55, convertible before 1930 into 5 class B common shares for one of preferred.[54]	$1,000,000	$997,500
Class B common, par $10, non voting, but participates equally		

[54] Has one vote per share in default of 8 quarterly dividends, as has class A.

	Authorized	Outstanding as adjusted
with class A in distribution of dividends and assets	500,000 shares	200,200 shares
Class A common, no par, voting	50,000 shares	26,314 shares

The common is evidently broken into two parts—a larger number of class B nonvoting shares and a small number of class A voting shares. But, curiously enough, the class A voting stock was sold in units with the preferred (which was convertible, as might have been expected, into class B nonvoting common). These units consisted of one share of preferred and one-half share of class A, and were sold for from $52–$55 per unit. This operation took up roughly 10,000 shares of the class A voting common, leaving the other 15,000 shares shown outstanding on the balance sheet for the organizers who thus reserved to themselves some two-thirds of the class. A voting common. Curiously enough, again, class B nonvoting common stock was offered separately to the public in January 1928 at $12.50 per share. To what extent the organizers trade on the equity, cannot be exactly determined. As the B stock is sold, the set up provides a substantial equity back of the preferred, but one which is contributed largely by the public.

PARTICIPATING PREFERRED PLANS

A second plan is to sell the public primarily a participating preferred stock, while the organizers purchase the common. Heie the amount of the common stock taken in conjunction with the basis of preferred participation, indicates the extent to which the organizers trade on the equity. The plan is used in a considerable number of cases. In its pure form, it has the advantage of creating only two securities, but the disadvantage of giving the preferred stock a hybrid character. In general, these plans carry but a small margin of protection for the preferred (which may, however, be regarded as really containing an element of common itself) and the organizers trade heavily on the equity.

Three simple illustrations are:

The First Investment Co., New Hampshire, (dating back to 1916)
Class A no par, but entitled to $50 in dissolution before any payment on class B, thereafter shares equally with class B stock as a class; preferred as to dividends of $3 per share per annum and participates equally as a class with class B in

any further dividends, . . . 20,000 shs. authorized, 16,623 shs. outstanding, Dec. 31, 1927.

Class B no par; carried in balance sheet, together with surplus, at $7.87 per share. 10,000 shs. authorized, 10,000 shs. outstanding.

While the exact basis of management participation cannot be determined, they apparently contributed less than one-tenth the capital in return for one-half the excess earnings.

Allied International Investing Corp., (created by Kean, Taylor & Co. and Baker, Kellogg & Co., Inc., in 1927)

Participating preference stock, $6 cumulative (no par, but entitled to $100 in dissolution and then two-thirds of remaining assets pro rata among its holders). Preferred as to cumulative dividends at rate of $6 per share and participates with deferred in any further dividends, receiving additionally two-thirds of amount to be distributed . . . Option to directors and associates to purchase all or any part of 10,000 shares at $107.50 to May 1, 1929, and thereafter at $115 per share plus accrued dividends. 60,000 shares authorized, 18,205 outstanding April 30, 1928.

Deferred stock (no par); in effect carried in balance sheet at nominal figure, a very weak situation which may account for the heavy participation by the preferred. Equity apparently to be built up from sale of preference at a premium and from earnings. 10,000 shares authorized, 3,800 outstanding.

The Mutual Investment Trust—A common law trust managed by The Mutual Investment Co., a joint stock association, under trust indenture with the Empire Trust Co. of N. Y., in 1926: Class A Prior Beneficial Shares, par $10 (no limited amount authorized, 29,680 outstanding Dec. 31, 1927) Entitled to cumulative preferential return of 6% per annum. After 6% is paid to class B holders, the excess income distributed is divided equally between the two classes of certificates, subject to accumulation of a reserve equal to one-eighth of the total fund. Redeemable at will of holder, subject to redemption charge of 2% of face amount and 25% of share of undistributed profits made while they held their certificates. Sold to public at price equal to asset value in fund plus 80 cents per share for distribution.

Class B Subordinate Shares, par $1. Owned entirely by the Company, which purchases them as class A shares are issued. This set-up may be summarized by saying that the public pays $10 for a sort of 6% cumulative preferred stock, the managers put up $1 junior money and both divide the excess earnings equally. The managers, however, assume all expense except the trustee's fees, brokerage, interest on borrowed funds and taxes if later imposed.

More complicated is the plan followed by Kidder, Peabody & Company in their three trusts, called, respectively, Kidder Participations, Inc., Nos. 1, 2 and 3, formed, respectively, in 1926, 1927 and 1928. In each case the public was sold a participating preferred stock, in units with common, and convertible into common—a three fold "cut" into the excess earnings, which seems unnecessarily complex. The set-up of the first and second was as follows (the right to borrow is reserved):

Participating preferred stock, 4½% cumulative, par $100, Authorized and outstanding 50,000 shares. Entitled in dissolution to two-thirds the amount paid on each common share after the preferred has received $100 per share and the common $1 per share. Preferred as to cumulative dividends at rate of 4½% per annum and participates with common in any further dividends receiving additionally two-thirds of amount paid on each share of common.

Common, no par, authorized, 100,000 shares, outstanding 50,000, carried in the balance sheet at $50,000.

The other 50,000 shares of common were reserved for conversion of the preferred—a "long range" conversion, share for share, of a stock carried in the balance sheet today at $100, into one now carried at $1. Of the 50,000 shares outstanding, 37,500 were sold to the public (in units of one preferred and three-fourths common at $102) for $75,000. Presumably 12,500 shares or one-fourth remained (gratis) for Kidder Peabody & Co., which agreed to manage the trust without compensation to itself. While this is a small minority of all voting shares (the common alone votes on calling the preferred at $125, but otherwise every preferred share casts one vote), the management would fall away if their control became ineffective. The third trust changed the plan in several features, though not in fundamentals. The rate on the preferred became 5% instead of 4½%, but its further participation was reduced to one-half the amount paid on the common shares. The investor bought one share of common with each share of preferred for $103.50, but the number of shares of common was increased to 150,000. Of these 50,000 were reserved for conversion of the common, the investors buying another 50,000 (one-half the balance) and Kidder Peabody & Company receiving the remaining 50,000 shares for $3.50 per share. The net result of the plan, it may be observed, was that if the new features had been applied to the first and second trusts, Kidder Peabody & Company's share of the annual earnings (whether distributed or not) would have roughly doubled—from about $39,000 to $78,000 and about $29,000 to almost $57,000, respectively.[55] In any case, the equity back of the preferred was very slight, altho the basic rate on it was low.

Another variant of this type of set-up is evident in the Standard International Securities Corporation formed in 1927. It has sold the public a unit composed of one share of 6% cumulative preferred stock of $50 par and one share of no par class A stock, initially at $60 per unit. The second of these two securities is actually a non-cumulative participating second preferred stock, entitled to $1.50 per share before Class B receives anything. After class B receives 10 cents per share, class A is entitled to additional dividends at the rate of $1.00 per share and class B to them at the rate of 15 cents per share. After class A has received $2.50 in all and class B 25 cents, additional dividends may be paid in the same ratios, with the same continuous priority.[56] Of the preferred, 400,000 shares are authorized, of class A 500,000, of which 50,975 and 75,975 shares, respectively, were outstanding March 31, 1928. Of class B no par common, 500,000 shares are likewise authorized, with 100,000 shares outstanding, for which the organizers paid $25,000, and the remainder of which (amounting to $100,000) they are required to pay for in cash in the ratio in which units are sold to the public. Voting power is entirely in the hands of class A and B stock unless one year's dividends on the preferred are defaulted, when it has one vote per share, the same as class A and class B. Neglecting the $1,000,000 of 5% one year notes outstanding March 31, 1928, the $2,548,750 of preferred was protected by $906,622 of class A common—all contributed by the public—and $25,000 of class B contributed by the organizers —proportions roughly of 102, 36 and 1. The plan may be summarized as involving a split of the preferred stock sold the public into two parts—the larger a straight preferred, the smaller a non-cumulative participating issue. Remarkable also is the extremely heavy trading on the equity by the managers.

The further variants of these ideas are legion. To take merely one recent case, the Sterling Securities Corporation, formed in 1928 by the Insuranshares interests, will sell a first preferred stock in units with common, is offering a 5½% cumulative preference stock (with additional non-cumulative participation of ½% if earned, resembling some British preferred stock) in units

55 In one sense, the Kidder Peabody trusts seem like formalized securities house accounts, in which the clients are sold participations. The later are mentioned in Chapter VIII.

56 The revised plan provides for a flat initial preference on the class A of $4, then $1.50 on class B.

with class A common (which is really a noncumulative participating third preferred) to the public, as well as units of preference, class A and class B (management stock) to founders to provide funds with which to get started. Dealers are also permitted to purchase class B stock in proportion to sales, but the bulk of the class B is taken up at 50 cents per share for initial expense by the organizing group. In short, the preferred is again divided, but both first and second preferred are being offered to the public separately in units with a third non-cumulative participating preferred (called class A).

FIRST AND SECOND PREFERRED PLANS

A third plan is to sell the public a first preferred stock, together with some common, while the organizers purchase a second preferred stock, together with the bulk of the common. The common in such cases is likely to be bonus stock and represent no real cash investment. The second preferred stock is obviously weak in such cases, but is held by the organizers, and protects the first preferred held by the public. The plan seems to possess a considerable degree of appeal to investors.

The United States and Foreign Securities Corporation, sponsored by Dillon Read & Company in 1924, employs this set-up. It sold the public the 250,000 shares of 6% cumulative first preferred stock, redeemable in whole or part at 105, at par for $25,000,000, the allotment certificates carrying one share of no par common for each share of preferred. The organizers bought the 50,000 shares of the 6% cumulative second preferred stock at par for $5,000,000, and received the remainder of the common stock. The result was that the 1,000,000 shares of common were divided, one-fourth to the public, three-fourths to the organizers. As the Attorney General of the State of New York remarks: [57] "The organizers, by thus furnishing brains and one-sixth of the capital will be entitled to three-fourths of the net profit." Back of 5 parts of first preferred is 1 part of second preferred and none of common.

A variant exists in the case of the Shawmut Bank Investment Trust, formed in 1927. Instead of first and second preferred stock, senior debentures and junior notes were used. The bank, together with certain foreign bankers, purchased at 104 the entire issue of $1,000,000 junior notes (25 year, 6%, series A), while the public purchased at par $2,500,000 25 year 5% and $2,500,000 15 year 4½% senior debentures, both redeemable as a whole or in part at 101. The debentures are protected by an

[57] Survey, p. 65.

asset clause, forbidding creation of additional obligations or retirement of notes unless the trust assets thereafter equal 120% of total debt, excluding junior obligations. The senior debentures carried non-detachable warrants entitling the holder of each 5% senior debenture to receive not earlier than one year from date of issue five common shares per $1,000 piece and of each 4½% debenture—evidently in consideration of the lower yield—ten common shares. The junior notes carried 37½ shares per $1,000 piece. In other words, the bankers put up about one-sixth the funds, and received one-half the net profits. Back of 5 parts of debentures are 2 parts of notes and none of common.

Among further ingenious variants may be cited Beacon Participation, Inc., formed in 1928 by the Beacon Trust Co. and Jordan-Lyman Co. Inc., of Boston. The principal officers and directors receive no compensation for managerial service. The trust company bought for $500,000 the entire 25,000 shares of no par class B participating preferred stock and the entire 25,000 shares of no par common stock. The public was sold the 100,000 shares of no par Class A, cumulative, participating preferred stock at $21 per share. It receives a dividend of $1 per share (roughly 5%), after which Class B is entitled to cumulative preference of $1 per share. All further dividends are divided: 40% to class A, 10% to class B and 50% to common. The same percentages obtain in dissolution after class A first receives $20 per share and then class B $20. In other words, the bankers put up about one-fifth the funds and receive three-fifths the net profits. The fact that their second preferred stock was made participating, gave them a twofold "break" into the excess earnings. Back of the 21 parts of class A are 5 parts of B and none of common.

Investors Foundation, Inc., formed in 1927 by J. A. Sisto & Co., splits the preferred sold the investors (in units with common warrants) into two classes, has the third preferred purchased by the organizers, and has an ingenious compensation in common stock for organizers as management and selling compensation. It sells the public a 5% cumulative preferred stock, series B ($160,000 outstanding of $400,000 authorized) at the $100 par, and separately a 5% cumulative preferred stock, series A (the $150,000 issue), which is really a second preferred stock, both callable at par, but not A while any of B is outstanding. The B stock carried a warrant entitling each holder to receive gratis one-fourth of a common share within one year after payment of initial common dividend or redemption of the issue, and the A stock warrants called for one share. Assuming warrants are continued on the same basis, the public buying the

B and A preferred, of a combined par value of $550,000, gets one-sixth of the total common shares. The organizers bought the entire 500 shares of no par $5 cumulative junior preferred for $70 per share, and paid $15,000 for a net amount of 5,000 shares of common. They assume the burden of management without compensation for seven years (except taxes and extraordinary legal expenses) other than in common stock, in accordance with the following agreement:

J. A. Sisto and Co. will receive as compensation for its service, a number of shares of common stock equivalent to 2½% of the total common shares outstanding (not including Treasury stock) at the end of the year 1927 and 5% of the total shares outstanding (not including Treasury stock) at the end of each year thereafter, plus (a) an additional number of common shares equal to one-quarter of the number of common shares issued absolutely (or made available under option warrants) in connection with the raising of additional capital over and above the initial of $50,000 paid in by J. A. Sisto and Co., and (b) 2 shares of common stock for each $1,000 additional capital raised without selling or otherwise issuing or disposing of common stock or warrants or rights to receive or subscribe to common stock.

The heavy trading on the equity is apparent, likewise the thinness of the margin back of the public's second preferred issue, much less the organizers'. In fact, certain cash equities are to be built up before any dividends are paid on the preferred. Yet the plan further contemplates issues of bonds and of senior preferred at a later date, with participation in common at a lesser rate than that obtained by capital previously subscribed.

BOND AND COMMON PLANS

A fourth plan is to sell the public bonds instead of preferred stock. The investors obtain a "break" on the common through bonus or purchase warrants, or else the bond is made convertible. Such plans are relatively rare in actual practice. Evidently the contingent nature of preferred stock charges is preferred initially to the lower rate that bonds bear.

The First Federal Foreign Investment Trust, organized in 1926 by F. J. Lisman & Co., is the only "Edge Act" trust in operation in the United States today. This Act permits heavy bonding,[58] but the trust has never made use of the privilege to the extent allowed. Of $5,000,000 authorized collateral trust gold 5's, series A, due 1932 (redeemable at a premium of from 1%

[58] See Chapter III, p. 49.

to ⅛%, according to date, and secured by 125% collateral) it had only $634,000 outstanding on December 31, 1927, as compared with $2,000,000 of the $5,000,000 authorized common stock of $100 par. Each $1,000 "debenture" carried a non-detachable warrant entitling the holder to buy three shares of stock at $112 before July 15, 1928; $114 before 1929 and $116 before 1930. Instead of bonding, the trust relies more heavily upon secured bank loans, of which $2,141,923 were outstanding. The Federal Reserve Act permits no trading on the equity by organizers against public.

The Financial Investing Company of New York, Ltd., organized in 1924, also has a bond and common stock set-up. Capitalization is as follows:

	Authorized	Outstanding
Secured 5's (part due 1930, most 1940) secured by 20% excess collateral	$4,000,000	897,000
Convertible 5's due 1932 (35 shares per 1000 bond) redeemable with premium ranging from 2% to ¼% according to date secured by 20% excess collateral	2,000,000	665,000
Common Stock par 10 reserved for bond conversion $700,000	2,000,000	968,080

In the secured bond financing, each $1,000 piece was accompanied by warrants entitling the holder to buy 20 shares of common at $17.50 per share, but in the second bond issue two years later conversion was substituted for warrants. The common stock was offered separately to investors, in 1925 at $15 per share, in 1927 at $20, and rights were offered later that year. To what extent the organizers traded on the equity cannot be determined. But the sale of common stock at a premium gave a substantial surplus—$430,579 as of April 30, 1928—which made the stockholders' investment almost as large as the bondholders. The charter of the Second Financial Investing Corporation limits bonds to twice the net worth.

FULL FLEDGED "BRITISH TYPE" TRUSTS—SIMPLER PLANS

Some trusts start full blown, with all three classes of securities. Others add the bonds only after at least six months or a year's experience.

Most clear cut are those plans in which the public buys bonds with a dash of the common, while the organizers buy the preferred and get the bulk of the common. This is similar in a way to the first and second preferred stock plans already discussed. The General American Investors Company, Inc., organized in

1927 by Lehman Bros. and Lazard Freres, affords an illustration. The public was sold $7,500,000 of 5% debentures, callable at 100, protected by a 120% asset clause. They carried non-detachable warrants entitling the holder to receive gratis ten shares of common for each $1,000 debenture, either when the first common dividend was paid or earlier at the company's option. For this purpose, 75,000 common shares were reserved. The bankers bought the 15,000 shares of 6% cumulative nonvoting preferred, of a par value of 100, callable at 120 and entitled in dissolution to 120. They also received the balance of the common, namely 125,000 shares, paying for both preferred and common $1,800,000. The ratio of bonds, preferred and common thus becomes 25: 5: 1—a thin equity of less than 25% over the bonds and 20% over the preferred. And the bankers, by putting up slightly less than one-fifth of the money, receive five-eighths of the net profits.

Similar was the plan followed by Domestic and Foreign Investors Corporation, organized in 1927 by A. G. Becker & Company. It sold at par to the public $2,500,000 of 5½% debentures, with warrants for 25,000 common shares. The bankers bought 5,000 shares of $6 cumulative no par preferred redeemable at 110, and the remaining 50,000 shares of common, both for $550,000. Here the ratios are 50: 10: 1, and the bankers, by putting up a slightly lesser percentage than in the other case, receive two-thirds the net profits.

The American British and Continental Corporation, formed in 1926 by Blyth, Witter & Co. and the J. Henry Schroder Banking Corporation, illustrated at the outset merely one of the first and second preferred plans described in an earlier section. The public bought 10,000 shares of a first preferred cumulative no par stock at $100, redeemable at 105 before 1930 and 102 thereafter, the organizers 4,000 shares of a $6 cumulative no par second preferred stock at $100. The bonus common (with exclusive voting power except in case of default on preferred dividends) was divided 100,000 shares with the first preferred, 300,000 with the second.[59] Thus the organizers put up two-sevenths of the money and received three-fourths the residual profits, while the capital structure was 5: 2: none. In 1928 $5,000,000 of 5% debentures due in 1953 (callable at 102½ before 1930 and 100 thereafter) were sold the public at 96, without common participation of any kind, and a full fledged British type trust resulted. The organizers put up four-nine-

[59] The public received allotment certificates, at first 50% paid, full paid allotment certificates being exchangeable for definitive stock certificates after Dec. 1, 1927.

teenths of the money, but continue to receive three-fourths the net profits. The structure becomes 5: 10: 4: and none—a well protected bond with 280% of assets junior to it, but weaker preferred issues.[60]

The Pacific Investing Corporation, formed in 1927 and financed through Blyth, Witter & Company, was developed in two stages. In June 1927 the public bought units of $3,500,000 first preferred and common consisting of two shares and one, respectively, the organizers units of $1,500,000 second preferred and common. In January 1928 expansion took place, both along similar lines and into a full fledged British type. The public was sold debentures with bonus common stock warrants (three shares per $1,000 piece) and also additional units of first preferred and common; while additional units of second preferred and common were underwritten. The result is that there are outstanding today:

	Authorized	Outstanding
Gold debenture 5's, Series A, due 1948 (callable 102 before 1933, 101 before 1938, par thereafter) Offered at 96½		$5,000,000
First preferred stock, 6% cumulative, par $100, (callable 105 before 1938, 102, thereafter)	$6,000,000	$6,000,000
Second preferred stock, $6 cumulative, no par, (redeemable at 100) (carried in balance sheet at $2,876,325)	30,000 shares	29,950 shares
Common stock, no par, sole vote except in case of de-		

60 A curious way in which to arrive at a full fledged British type is shown by the Continental Securities Corporation, organized in 1924 by four leading banking houses. In 1927 the public bought $5,000,000 of 5% debentures, series A, due in 1942, with stock purchase warrants for three common shares at $63.50 per share by 1932—or three-tenths of the common. The organizers had paid $1,750,000 for the remaining 35,000 common shares. In 1928 stockholders received rights to subscribe to 15,000 shares of $100 par value preferred and 10,000 shares of common, in the rate of three shares of preferred and two of common per ten common shares held, at 440 per unit. The Corporation will have bonds owned entirely by the public, and preferred and common owned jointly by organizers and public.

fault on first preferred	250,000 shares	118,250 shares
Common stock purchase warrants for:		
1000 common shares at $10 per share		500
61,492 shares at $10 per share, by 1937.		

The ratios are therefore 5: 6: 2.9: and none, but to them will be added 1.1 for common when the warrants are exercised. Evidently there is some common reserved for additional bond financing. Of the funds paid in to date, eleven parts were contributed by the public to less than three by the organizers, while the respective common holdings are forty-five parts and over seventy-three parts—in other words, to date the organizers have contributed about one-fifth the capital for two-thirds the net earnings. It is only fair to add that directors serve for five years without compensation and will pay expenses other than taxes during the first two years, not exceeding in the aggregate $90,000.

FULL FLEDGED "BRITISH TYPE" TRUSTS—MORE COMPLEX PLANS

The Investment Company of America, formed in Michigan in 1926 by E. E. MacCrone & Company of Detroit, represents a case in which the public is sold bonds with common stock purchase warrants, as well as units of preferred stock and common plus additional common stock purchase warrants. The public supplies all the money at the outset, the organizers merely receiving specified options to purchase common stock. The managers paid all expenses for the first year and thereafter officers and trustees were compensated only through their options. The bonds followed after six months' experience under preferred financing. The details are these:

$5,000,000 debentures, 5% series A at 97: callable up to 1930 at 103, thereafter at 100. Each $1,000 piece has 10 warrants, to buy one share by 1930 at $32.50, by 1934 at $35, by 1937 at $37.50.

50,000 shares preferred cumulative, 7%, series A, par 100, callable 110, sold in units of 1 preferred, 1 common and 1 warrant to buy 1 share common before 1937 at 30.

300,000 shares common authorized:

50,000	reserved for bond purchase warrants
50,000	" " preferred stock purchase warrants
50,000	sold in units with preferred
50,000	under option to organizers to buy by 1937 at 26
100,000	" " " " " " " " " 30

After six months the structure is 100, 100, 17. The last figure, in fact, is actually less, since the balance sheet carries only $350,000 for common instead of the $850,000 paid in, which would make it 7, instead of 17. Certainly this equity is exceedingly thin, especially in view of the 7% preferred dividend rate. When financing is completed, the picture will of course be righted. Assuming warrants are exercised at the minimum figures, the ratios become 5: 5: 6.775, close to the British type. But the trust gets the junior money later, when it needs it less urgently, and it is forced to "jazz up" its securities instead at the outset. The organizers, of course, are enabled to play safe and to put up the money at their convenience, so that they merely gamble at first with their time and good name. When financing is completed, the public has furnished some $13,800,000 and the organizers some $4,300,000; for a little less than one-fourth the money, the latter get one-half the net profits by owning half the 300,000 common shares.

The Second International Securities Corporation was formed in 1926. Its initial plan of financing was by the use of first and second preferred stocks. But the amount of second preferred outstanding (all held by the American Founders Trust) was to increase as the first preferred held by the public increased. The common, too, was split into the two A and B classes already described in Chapter V, the A to be held by the public, the B by the managers. After a certain record of achievement, the managers' two securities were to be convertible into the public's—B into A and second preferred into first preferred, the public thus having preference in the initial period of uncertainty.[61] After a year and a half, some straight bonds were sold to the public, without any common participation. The securities are briefly as follows:

	Authorized	Outstanding
Gold debentures 5% due 1948 (callable at 103 to 1931 to 100 after 1946)	$ 7,000,000	$7,000,000
First preferred stock cumulative 6% series par $50 (callable at 105)	30,000,000	9,500,000
Second preferred stock cumula-		

61 The present International has only one class of preferred but has the two classes of common, as well as the bonds. In the reorganization in 1927, when it changed from a Massachusetts trust to a Maryland corporation, the option to American Founders Trust to purchase some International common was commuted into outright purchase at once of a given number of such shares.

	Authorized	Outstanding
tive 6% series par $50 (a particular number convertible into first preferred whenever 12 months' earnings aggregate 3 times annual first preferred dividends and dividends on that number of shares of second preferred)	$3,000,000	$1,000,000 [62]
Class A common, no par	800,000 shs.	155,000 shs.
" B " " "	600,000 "	600,000 "

(A and B have sole voting power except in default on preferred dividends)

Three pieces of public financing took place. In November, 1926 120,000 units of one share first preferred and one share A common were sold at $65 per unit. In October, 1927 70,000 units were sold at $70 each, composed of one share first preferred and one-half share A common. In February, 1928 the $7,000,000 bonds were sold at 95½.

In order to sharpen the outlines, the following skeleton table of approximate security amounts (in millions of dollars) may be presented:

	November 1926	October 1927	February 1928
Bonds	–	–	7
First preferred	6	9.5	9.5
Second preferred *	1	1	1
Common A	1.8	3.2	3.2
" B *	.8	.8	.8
Total	9.6	14.5	21.5

* Held entirely by American Founders Trust

Contributed by			
Organizers	1.8	1.8	1.8
Public	7.8	12.7	19.7

The safety of the set-up can hardly be criticized; but it is built up largely by funds paid for common stock by the public. The

[62] All owned by American Founders Trust; class B bought for $1,800,000 cash; 20,000 additional shares of second preferred to be bought for $1,000,000 when amount paid in on first preferred aggregates $10,000,000 and another when it aggregates $20,000,000.

extent to which the equity is traded on is worthy of notice. The authorized capital seems to contemplate a 10 to 1 ratio between the public's preferred and the organizers', to which is to be added the bonding that takes place. While the organizers paid for their B common, the price was only $3 a share, although the A common last sold the public brought $40 per share (after a one year's record for the trust) and the initial brought $15 a share. Of course, the earnings after preferred dividends during the fiscal year ended November 30, 1927 were only $447,821, of which $387,500 would be absorbed by a $2.50 dividend to which class A stock is first entitled and the balance would fall far short of the $900,000 at $1.50 per share, to which class B is next entitled.

Equally complex is the plan adopted by the Standard Investing Corporation, formed in 1927 by Brown Brothers & Company and Stone & Webster & Blodget, Inc. The public initially bought bonds with a bonus of common, while the managers bought a convertible preferred with a block of the common, not required for conversion or other purposes. The public received $4,500,000 of 5% 10 year debentures at par, redeemable at 102 to 1929 and par thereafter, each $1,000 piece carrying a nondetachable warrant for 10 shares of common gratis after about one year from date of offering. The bankers paid $1,500,000 for 15,000 shares of $6 dividend series cumulative no par preferred, each share convertible into four shares of common and callable at 115. With this they received 40,000 shares of common, the other 45,000 outstanding of the 185,000 authorized being reserved for the debenture warrants, and 60,000 more of the unissued being required for preferred stock conversion. Initially, then, it would seem as if the bankers, by putting up one-fourth the money would get eight-seventeenths of the net profits. The structure would be 3 parts bonds, 1 part preferred and none of common—obviously a thin equity.

But this takes no account of the conversion privilege nor of the possibility of issuing additional preferred. About one year after the initial financing, additional preferred, nonconvertible, was sold to the public, with common stock purchase (not bonus) warrants attached. Thus in January, 1928, 40,000 additional shares of the 100,000 authorized were issued. But this time they were of a $5.50 dividend series and, though cumulative, were not convertible and were callable at 110 before 1933 and 105 thereafter. They were offered with non-detachable stock purchase warrants, whereby each share carried a right to buy one share of common at $30 before December 31, 1930, $35 by three years later and $40 four years after, by 1937. This takes up the remainder of the authorized common stock.

On August 1, 1928, the trust called the bankers' preferred stock for payment, which would give them the opportunity of withdrawing their entire initial investment at a good profit, or else converting it entirely into common. They thereupon chose the latter and converted it into common. The net result, therefore, is that after the common stock purchase warrants have been exercised, assuming that to be done at 30, they will have put up some 13% of the capital and receive twenty-thirty-sevenths of the excess profits. Had they elected to retire their funds, they would continue to receive some $\frac{8}{25}$ of the net profits for having temporarily advanced them. The structure will become (neglecting surplus) about 15: 11: and 9, and would have been if the bankers had withdrawn their funds 11: 10: and 3—a good example of how stock purchase warrants build up an equity when the trust has less need for it, having been left to weather the early storms without such aid. Of course, the purchase warrant brings in cash where a bonus warrant did not, and the former is sometimes used after six months' experience as a substitute for the latter, causing the investor to pay more for his securities; but the issue of bonus stock is to be condemned.[63]

[63] The Investors Equity Company affords an interesting instance of changed offer to the public as the trust becomes "seasoned."

CHAPTER VI

CORPORATE TYPE TRUSTS—INVESTMENTS

The typical corporate investment trust is of the general management variety. It holds a varied list of securities—bonds as well as preferred and common stocks, originating abroad as well as at home. Far less frequently is it specialized in its investments and confined largely if not entirely to one class of securities such as bonds or mortgages, common stocks of domestic companies, or shares of financial institutions, public utility or oil enterprises. The characteristic American trust, as well as the British, covers a wide investment field.

Income arises largely from investments, returns from underwriting and other miscellaneous operations being small. The fact that a large part of the capital employed is hired at a fixed rate of return leaves a much higher rate for the common stock, which is further increased as time goes on by the growth in the trust's capital as surplus and reserves—actual or concealed—are built up.

In order to understand the investment policy employed, British method must be distinguished from American. Most important is the different objective sought. American trusts, due possibly in part to the thinness of the common stock equity mentioned in the last chapter, also possibly in part to the influence of the newer theories of investment developed especially since the war, emphasize turnover far more than do the British trusts on which they are ostensibly based.[1] British trusts, which do not treat turnover

[1] The older British trusts, of course, have measurably lightened their task by the low rates at which debenture and preference share

gain as current income, place more emphasis on careful selection of individual issues for long run investment. Related to this difference, is the fact that the British do not build up an elaborate investment mechanism. They rely upon the contacts and experience of their directors, while American trusts in a number of cases build up elaborate statistical organizations and devise more or less complex objective tests. British trusts maintain an independent investment position, as already remarked, to a greater degree than do American trusts, many of which are sponsored by security houses. Finally, the British tend to repose almost unlimited discretion in the integrity and skill of the management, while the American, due possibly to the newness of the organization in the United States, more often develop more or less elaborate formal restrictions upon investment operations in the effort to reassure the investor. Neither are hedged in by legal restrictions.

COMPOSITION OF THE PORTFOLIO

The English place little emphasis upon formal investment restrictions. The management is given almost free rein—generally only directed not to put over five per cent of the assets in one security, but otherwise to exercise its complete discretion.[2] In the United States there are two schools of thought. The International group, as well as some of its offspring and a number of other trusts, have rather extensive requirements and self imposed restric-

capital has been obtained. On each pound, they show a nice margin of current investment income remaining for the ordinary shares.

[2] Campbell, E. M. Some Management Problems of Investment Trusts, Harvard Business Review, April, 1924, p. 296, states that "all the older companies have found it necessary from time to time to widen their powers and their field of operations."

tions.[3] But a larger number—especially those trusts formed by well known security houses—follow the British plan, or even in rare instances permit their managers to diversify as much or as little as they please, having no restrictions in either charter or by laws.

British trusts therefore place reliance almost entirely upon the integrity and ability of the managers. And during the course of British trust history, a group of experienced and skilled trust managers has developed. They have had the opportunity to develop unwritten standards, in mind yet never transmitted to paper, to guide in making their investments. Such standards have been flexible, and subject to modification as needed in the individual case. On the other hand, formulation of definite standards affords protection to investors and reassures them in the early days of the movement. But it is extremely difficult to lay down any but the broadest of generalizations. Investment can be but illy defined by mechanical or automatic means. Attempt too rigid definition and the restriction becomes a handicap, rather than a help, as those who framed American savings bank investment laws or come under them well realize. Restrictions laid down in the same group of trusts, in fact, differ from one to another, with a tendency towards greater liberality in those formed later. The British attitude towards the whole problem of trust investment is perhaps best illustrated by "the familiar words of a celebrated painter, who, when asked by a student, with what he mixed his colors, replied, 'With brains, Sir!' "[4]

3 Robinson, p. 285, states that they were elaborated after study of American legislation defining trustee investments, blue sky legislation and British trust standards. So far as possible, alternative criteria are provided in order to preserve flexibility.

4 Campbell, p. 300.

In the field of investment which it selects for itself, a trust must reach a decision on at least two matters.[5] It is with respect to the following that such restrictions as exist relate:

1. Quality or intrinsic soundness of securities
   a. Age.
   b. Assets.
   c. Earnings.
   d. Market.
   e. Special features—absence of control, single liability of holder.
   f. Condition of country where issued.
2. Diversification
   a. Numerical.
   b. Geographical.
   c. Industrial.
   d. Security.

American trusts contain a considerable variety of provisions on these topics and only the chief outlines can be sketched. Their exact practice within the limits they set for themselves can be ascertained from such published data of holdings as exist. To the latter, also, recourse must be had for an understanding of British policy. American trusts, it may be observed in passing, generally require sale of a security within six months or one year after it ceases to be eligible.

[5] The different writers on investments have classified investment risks in various ways. Van Riper treats them as five fold:
1. Credit risk.
2. Money risk, due to variations in purchasing power.
3. Act-of-God risk.
4. Progress risk, due to invention, etc.
5. Risk of market, due to business cycle.

Skill and diversification, he feels, are the important features in overcoming them, and the trust supplies both of them in higher degree than the individual investor.

American Investment Trusts, Barron's, May 24, 1926.

SECURITY TESTS

Unseasoned securities often carry great opportunities for profit. Illustrative of English practice, as has often been pointed out, is the fact that the cable address of a great London firm having much to do with investment trust management is "Fledgling Stock." Not only may the trust subscribe at time of underwriting, but also when an issue has failed and stays on the hands of the guarantors. Of course, selection of such issues requires nice judgment, and is not exactly reassuring to the investor. Hence some American trusts specifically bar promotion and business finance, as well as business management. They require that information be available on such matters as history, management, assets, earnings and dividends, perhaps for a given number of years, such as three and less often four or five, or else that the company has been established for such a period. Other trusts, however, are more liberal. Some name a percentage of the assets, for example, twenty per cent, which may consist of securities of more recent origin.[6] This is the case with the International's succeeding trusts; it itself was confined to seasoned securities. A few trusts evidently have in mind acquisition of other trusts and therefore except investment therein.

An assets test, whereby book value is to bear a certain relation to purchase price, is difficult to frame adequately. Why this should be so is evident when the course of the securities market in recent years is considered, to say nothing of the vagaries of corporation accounting. The International and its successors avoid such a requirement alto-

6 The California supervisory authorities, in their twelfth rule, limit investment to companies in successful operation for at least three years, but, where and when good cause exists that the provision will prove injurious to the trust's operation, permit not more than 20 per cent of its resources to be placed in securities of more recently organized companies. Keane, p. 806.

gether, but the American Founders and the Standard International require that at least seventy per cent and eighty per cent respectively of the investment in railroad, public utility and industrial securities shall show a minimum book value at time of purchase of one hundred fifty per cent for bonds, one hundred twenty-five per cent for preferred and one hundred per cent for common stock. The Founders further adds that not over thirty per cent may consist of income or dividend paying securities having a book value less than the purchase price. One small trust wants ninety per cent of the securities it takes to have a book value of one hundred and fifty per cent of cost. The Financial Investing Company of New York, Ltd., fixes the following standards:

Bonds, etc., secured by marketable securities—110% of collateral to amount of issue.

First mortgage bonds	— 150% of assets to purchase price.
Other bonds, etc.	— 200%
Preferred stock	— 200% or payment of dividends for five years.
Common stock	— 250% or payment of four per cent dividends for five years.

The assets requirements for stock are undoubtedly of little practical importance, and it is interesting to note that the Second Financial Investing Company abandons an asset test altogether. Allied hereto, some trusts specify the margins to be required on call loans made, varying from loans of eighty-five per cent of value to a twenty-five per cent margin. Very rarely, such call loans can be made only against securities eligible for purchase.

An earnings test is equally rare among American trusts.

One trust requires earnings to be two and one half times dividends, or twice interest paid. Another requires securities other than bank stock to have a yield of from four to six per cent on purchase price, according to the class named. Finally, a third requires seventy per cent of the assets to consist of securities of companies (1) which for each of the five preceding fiscal years have shown earnings applicable to dividends on junior securities, (2) whose earnings for each of the three preceding fiscal years have been greater than the year before and (3) whose earnings for the last fiscal year applicable to the security have been fifteen per cent of its cost. Whether such detail is useful, is open to serious doubt.

In order to guard against an illiquid portfolio, a number of trusts require that the securities taken be readily marketable. A few—especially those with domestic leanings—make the test more definite by requiring listing on specified exchanges, for example, that fifty to seventy percent of the securities must be listed on the New York Stock Exchange or some recognized stock exchange or one situated in a city of 500,000 population. In practice, of course, most companies guard against having a considerable portion of their capital in unquoted securities, which they avoid except in special cases.

A number of trusts specifically oppose control, forbidding any purchase for that purpose. Some further limit purchase of a corporation's securities to twenty per cent of the par value or the number of that class outstanding. Like British trusts, a number forbid purchase of a security entailing unlimited liability.

Evidently a result of war conditions, the International requires that the history of a country in which investment is made must show financial stability and recognition of private rights. The Financial Investing Company of New

York, Ltd., adopted a similar clause, but provided as an alternative a guarantee of both principal and income by a governmental authority, corporation or organization whose own securities would be eligible for purchase. One other trust requires the country to have either a gold currency or a stabilized exchange currency basis. Otherwise the provision is not found. In actual practice, American trusts seem to take a good many foreign currency securities. The International and Second International hold only 57.5% and 40.9% respectively of their portfolio in dollar securities, and have as high as 22.9% and 28.1% in mark securities.

DIVERSIFICATION STANDARDS

Some British trusts, especially those quasi trusts better called financing investment trusts, which combine promotion and finance with investment, specialize in a certain industry or a group of related industries, such as rails, public utilities or, among the industrials, tea, coffee, rubber, mines, realty and oil. The typical British trust, however, holds all classes of securities in all four quarters of the globe. Its portfolio, limited in size by the dual necessity of being large enough to permit the so-called law of averages to operate, as in insurance, yet small enough to enable adequate supervision, ranges all the way from about one hundred issues to one thousand, with four hundred perhaps average, the larger trusts naturally tending to carry a greater number of securities.

In American practice, considerable difference appears between the International group and others. Trusts of that group are required when well established to hold at least four hundred issues (American Founders Trust two hundred) and the latest statements show over five hundred (over three hundred for Founders). On the other hand, other trusts held in general at the opening of 1928 less than two hundred; the Pacific Investing Corporation, almost as large as the Second International, held only one hundred thirty-nine issues, the Standard Investing, with two thirds the resources, one hundred fifty-two, and The Financial Investing Company of New York, Ltd., had two hundred fifteen, with resources of less than two million. The United States and Foreign, which has a strong financing admixture, had its thirty-seven million laid out in only one hundred and twenty-one issues and the American, British and Continental Corporation had its seventeen million in one hundred twelve issues. To what extent this practice will be continued in future, cannot be foretold.

Most commonly British trusts stipulate that not more than five per cent of issued share and debenture capital shall be invested in any one security or enterprise. Ten per cent is also frequent. A few set only three per cent or four per cent, while others permit much greater holding. Frequently an exception is made in favor of securities issued in the United Kingdom or obligations of the British government. Occasionally different restrictions exist for original than for subsequently issued capital. In practice, many British trusts hold a much smaller percentage in any one issue, other than government bonds during and after the war.

In general, American trusts set the figure at five per cent or ten per cent of assets.[7] The International's basic figure, in fact, was as low as one and three fourths per cent and that of its second trust three per cent, which latter figure holds for some others also. Certain trusts except governmental obligations, especially those of the

[7] The California supervisory authorities, in their eleventh rule, set five per cent. Keane, p. 806.

United States and Great Britain, and/or securities of banking institutions, insurance companies and investment organizations, either in toto or to some slightly higher figure. In rare cases, a higher percentage, such as twenty per cent, may be held temporarily, or a dollar amount or percentage is set varying with the size of the assets, which is relatively less for a larger trust—for example, ten per cent when less than one million and five per cent thereafter. Trusts tend to be well within the formal limits set; the International claims less than one per cent other than for United States government obligations as an actual maximum, the Pacific two and fifty-three hundredths per cent and the American, British and Continental three per cent (for a short term note due in less than six months).

Limitation of securities issued in or by one country is not usual among British trusts, and the few provisions found lack uniformity. In practice, some of the larger trusts seem to hold today between thirty and forty per cent and in some cases fifty per cent of their assets at home, with an additional seven to fifteen per cent in the dominions. American trusts, formed after the world war with its disturbed political and economic conditions, have tried in a number of cases to work out a careful set of requirements with respect to geographic distribution of their funds. The maximum amount to be held inside the United States is usually not fixed, except by the International (seventy per cent) and the Financial Investing Company of New York, Ltd. (seventy-five per cent). Both abandoned any such provision in their subsequent trusts. The usual maximum figures for any foreign country range from fifteen per cent to thirty-five per cent, with Great Britain often excepted in toto or set at a higher figure, such as fifty-five per cent for the International in place of thirty-five per cent. American practice today is illustrated in the following data of actual percentage holdings at the close of 1927:

	American Founders *	International	Second International	Investment Co. of America	American British & Continental	Standard Investing	U. S. & Foreign	Shawmut Bank
United States	63.5	29.8 **	21.7	80.2	26	55	89	56.2
British Empire & its possessions	5.1	1.9	4.9		56.5 ***			43.8
Continental Europe	24.3	57.4	64.2	5.8 ***		45	11	
Central & So. America	3.5	7.6	6.1		12.5			

* Figures reflect large holding of stock of its affiliated trusts.
** Includes cash, bankers' acceptances and treasury notes.
*** Europe.

American trusts that employ investment restrictions also seem to favor limitation of the amount that can be invested in one industry. Some specify a blanket figure of ten or fifteen per cent of assets. Inasmuch as hazards vary in different industries, however, others employ a more or less complete scale. For banks, insurance companies, investment organizations, railroads and sometimes public utilities, they permit twenty-five per cent each, and twelve and one half per cent for any other distinct class of industry. This plan is followed by the more recently formed trusts of the International group. Several other trusts employ a different grouping, for example thirty per cent to forty per cent each for transportation, public utility, financial and sometimes government securities, with the same figure or a smaller one, such as twenty per cent, for other branches. This plan is followed by the Financial Investing Company of New York, Ltd., and the Investment Company of America. The latter adds the requirement that not over half the percentage permitted for any one country may be invested in securities other than those issued by the government or a political subdivision. Where trusts hold large amounts of foreign securities, governments bulk large; thus the International and Second International hold 37.5 per cent and 35.3 per cent respectively of their total assets, including cash, in government obligations and the Shawmut Bank trust 15.3 per cent, as against only 3.2 per cent of the assets (excluding cash) in the case of the Investment Company of America.

The greater part of British trust assets consist of bonds and preferred stock, and the purchase of British government obligations during the war served to increase the proportion. But many trust portfolios contain a considerable proportion of common shares. Often they hold several classes of securities of the same enterprise. Several larger trusts hold between fifty and sixty per cent in bonds, debentures and debenture stock, but one of the largest only thirty-seven per cent; each holds around sixteen to twenty-five per cent in preference and guaranteed stock; and the balance—from twenty to thirty per cent, and for the one cited forty-four per cent, in ordinary shares. Few, however, set the proportions of the capital which may be placed in the different types of security and the same holds true also for American trusts. Two of the latter require at least fifty per cent bonds, hence not over fifty per cent stock, which is rather close to British practice. Another combines an industrial and security type classification, setting an upper limit of twenty per cent each for mortgage bonds of utilities or industrials and seventy-five per cent for common and preferred stocks of all kinds other than bank and insurance stocks. But these are curiosities introduced by less known trusts, and are of little value. Current American practice is shown by the following percentages:

	American Founders *	International	Second International	Investment Co. of America	Pacific	American British & Continental	Standard Investing	Shawmut Bank	Old Colony	U. S. & Foreign
Bonds and notes	47.8	78.5	67.5	28.5	22	73	34 ***	67.0	39.6	2
Preferred stock	24.2	3.3	4.0	26.7	21	22	58	32.4	25.4	94
Common stock	28.0	3.1	17.3	32.8	38.5	5				
Cash, etc.	— *	15.1	11.2	12.0	18.5 **	3	8	.6	35.0	4

* Included with bonds.
** Includes short term loans.
*** Includes advances, loans, etc.

It should be borne in mind that the actual figures given for American trusts apply only to the end of 1927 or the beginning of 1928, and must not be regarded as typical for all time. Especially is change noted in geographic distribution and type of security held, as will be explained in the following section. Notice the divergence between the two International trusts in their attitude towards common stocks. Notice also the relatively heavy common and preferred stock holding as compared with bonds of the fourth and fifth trusts, both served by the Investment Research Corporation, as contrasted with the International group. This factor is related, of course, to the former's emphasis upon domestic securities. Finally, notice the contrast between the two Boston bank trusts, with respect to cash position, as contrasted with bonds.

A tendency which may be mentioned briefly is that of one trust to hold securities of others, which obtains both among British and American organizations. This may tend to narrow diversification and concentrate risk more than at first appears, insofar as investments held by the trusts duplicate each other. The idea of a super investment trust, advanced by one organization, which is to hold solely securities of other trusts, appears, however, open to question. If the trusts are well selected, the plan will succeed; if poorly selected, it will fail. In any event, it appears to have but little automatic virtue, and, if the trusts are well selected, seems to be like creating an investment trust holding only reliably guaranteed mortgage bonds in the duplication of the investment mechanism provided.

TURNOVER POLICY

British trust policy may be characterized as involving careful selection of securities on the basis of intrinsic value. The security undervalued at the moment is purchased; later, when over-valued, it is sold and the funds used elsewhere. Little direct effort is made to judge the trend of the security markets as a whole and to time security purchases to accord with the general swings. They take the long run investment point of view, in which turnover is incidental.[8] It is true that trust policy is now more alert and turnover greater than in the past.[9] But the only British trusts consciously avowing turnover as a cardinal factor are those recently formed by stockbrokers. The Independent Investment Company, Ltd., formed in 1927 with J. M. Keynes, O. T. Falk, a London stockbroker, and T. J. C. Gifford, a Scottish writer to the signet (solicitor), as directors, for example, includes the following statement in its prospectus:[10] "This Company has been formed . . . to carry on the usual business of an Investment Company,

[8] British trust policy is nicely characterized by the following observation of A. E. Davies, Chairman of the Coöperative group of trusts: "An investment trust does not require pushing young men; it matures of itself, even though it is less fruitful than would be the case if it followed a more active policy." P. 179.

[9] Compare Speaker, pp. 44–5.

[10] Quoted in Robinson, pp. 110–111. Certain Scottish trusts whose funds have been invested largely in equities have shown a turnover profit exceeding the earned income.

aiming at obtaining a higher return on the capital employed than is open with safety to the individual investor, and also having special regard to certain principles of investment which are now well recognized but have as yet been acted on in only a limited measure. It is now known that fluctuations in the relative values of long-dated and short-dated fixed interest securities and also of fixed interest securities generally and of ordinary shares are all affected by a periodic credit cycle. Changes in the short period rate of interest affect the value of long-dated securities to a greater degree than should strictly be the case, with the result that considerable profits can be made by changing from one class to another at the appropriate phases of the credit cycle. Similar periodic changes also take place in the relative values of money on the one hand and of goods and real property on the other, which are reflected in the relative values of bonds and of shares, representing as these do respectively money claims and property, so that here also the same principle of changing from one class to another at appropriate times can be applied.

"The result of accumulated experience on these matters is to make it clear that the course of events is sufficiently regular to enable those who are in close and constant touch with the financial situation in certain instances to anticipate impending changes in the course of the credit cycle.

"Whilst the Directors will carry on the business of the Company on the stable lines recognized by sound Investment Companies, they intend in addition to avail themselves of the above principle by moving from one category of investment to another whenever the general situation indicates such a change to be advisable. This does not imply any intention to adventure the funds of the Company upon investments which would not be considered suitable for a prudently managed Investment Company. Indeed the policy of moving from time to time from one category of investment to another will require that the funds of the Company should in the main be employed in investments which are readily marketable, and which are among the leaders of their class. It will be the object of the Directors to create an organisation which will enable the ordinary investor who is unable or does not desire to pay constant attention to his individual holdings to obtain all the advantages of close supervision of his investments.''

American trusts, on the other hand, regard turnover as a leading objective. As much by this means, as by selection of individual securities, do they seek to achieve the ''economic profit'' in investment—earnings above market rate of interest—of which Dewing writes.[11] In part this results from the thinness of the common stock equity, so that, if the common stock is to be worth anything, it must be made so by trading profits. In part it reflects the newer investment theory developed largely in post war years, when the earlier distinctions between speculation and investment have been broken down. Several writers have preached the gospel of equity securities.[12] Common stocks have become exceedingly popular in the United States as long term investments. This theory has been developed during a period of rising commodity prices, wherein the holder of creditor securities suffers as the purchasing power of money declines. Moreover, during the period the country has developed rapidly and some concentration in business has been going on. The war period gave a sharp stimulus to American business and accentuated

[11] The Financial Policy of Corporations. Rev. ed., New York, 1926, Book V.

[12] How to Invest When Prices are Rising, New York, 1911; E. L. Smith, Common Stocks as Long Term Investments, New York, 1925; K. S. Van Strum, Investing in Purchasing Power, New York, 1925, and the various studies for the Barron contests on Investing for a Widow, etc.

these tendencies. Thus the comparisons which have been made show but sorry results for bonds as compared with common stocks.

From this analysis have developed certain canons of investment policy. The upward secular trend of stocks is marred by cyclical disturbance and greater profit can be made if cognizance is taken of that fact. Stocks may be bought when depressed, carried up to the peak, then sold and capital gains realized, the sum being invested in bonds or other creditor securities which will at least maintain their value if not rise somewhat as interest rates fall, until stock prices are again low. A further refinement is introduced by the International group of trusts. They seek to have appreciation continuously going on. Instead of confining operations to a single market, as the other theory suggests, if search be made of world markets, some will always be found depressed while others are booming. Purchases should be confined to the former, the latter avoided. As conditions change, and the tables are turned, securities held in one market should be sold and purchases made in another.[13]

The general theory is of course much more easily stated than applied. The International, by its statistical tests, eliminates all but fifteen per cent of the securities appearing in the important world markets.[14] But when it is reflected that more than 200,000 different securities are found, 30,000 must be considered, which is quite a task. From these securities must be selected those whose market price is below their intrinsic value, hence yield a potential profit. The later writings of this trust's officers admit the possibility of loss on some transactions, merely stressing

[13] But their operations, of course, largely involve "taking bonds up," rather than stocks.

[14] Robinson, p. 287.

the much greater possibility of gain as a whole. A serious objection to reliance upon turnover profits is that economic and financial conditions are much more favorable at one time than at another and hence regularity is difficult to achieve, while stability of current interest and dividend income is apt to be sacrificed.

AMERICAN TURNOVER EXPERIENCE

American trust practice with respect to turnover differs greatly. Some trusts are frankly more speculative than others; while many make profits from financing as well as investment. It is well known that some of the larger trusts obtain considerable returns from well equipped and expertly staffed trading departments. The International expects "that a yearly average of from ten to twelve per cent can be earned, on its entire invested capital, of this from six to seven per cent representing the purely investment return and the remainder the realized gains on turnover."[15] While its reports do not separate turnover from other profits, some data exist to test actual performance for the year ended November 30th, 1927:

	International	Second International
Average net bond and share capital and surplus	$33,301,500	$10,444,800

[15] Robinson, p. 295. For the year ending Nov. 30, 1925, it actually earned $105,962 on turnover, as compared with $325,406 as interest and dividends. P. 379. Fowler, p. 139, states that the policy of this group is to turn over from 50% to 70% annually. With this may be compared the (London) Financial Times data for British trust earnings (per cent of gross revenue, less income tax) on capital employed:

		Thirty London Companies	Twenty-Four Scottish Companies
1927–8	Average	6.77	6.75
	Range	4.93–9.48	5.51–8.73
1926–7	Average	6.42	6.71
	Range	4.69–10.69	5.87–8.79

	International	Second International
Earned from interest, dividends and realized investment profits	4,105,681	1,106,672
Turnover profits, allowing 6½ % as average interest and dividend return	1,941,084	427,760

Thus the International earned on turnover some five and eight tenths per cent before expenses and taxes, while the Second International earned four and one tenth per cent. For 1926, the former stated its gross cash earnings as fourteen per cent on average capital employed. The International, it may be added, has always been reputed to turn over its portfolio rapidly. This is evident from the fragmentary data showing changes in proportional holdings of different types of securities:

	November 30, 1927	April 30, 1926	September 1, 1925	January 31, 1924
Bonds	78.5	54	74	75
Preferred stock	3.3	30	22 *	21
Common stock	3.1	16	4	4
Cash, etc.	15.1			

* Includes bank stocks.

Some others among the larger trusts report turnover profits separately from interest and dividend income. These figures are available mostly, however, only for the single year 1927 and hence hardly representative. Lack of accounting standardization also doubtless affects their comparability. To them have been added approximate figures for capital employed during the year:

	Capital	Interest & dividends	Realized investment profits	Total income
U. S. & Foreign	$34,264,783	$1,760,781*	$1,729,226	$3,490,007
General American (11 mos.)	10,619,985	450,638	1,290,362	1,741,000
American, British & Continental	16,574,314	1,132,222	388,403	1,520,625
Standard Investing	10,086,795 ***	373,231	270,347	643,578
Pacific (About 8 mos.**)	4,996,981	90,804	112,352	203,156
Allied International	2,679,859	71,641	57,884	129,525
First Federal Foreign	5,038,092 ***	262,888	146,277	409,165
Shawmut Bank	6,138,174	306,226	176,962	483,189
Old Colony	10,343,525 ***	364,870	18,126	382,996
Mutual	257,000 ****	15,953	5,249	21,202
Financial Investing	2,846,120 ***	91,458	82,508	174,223

* Less interest paid.
** For year, total income was $747,864.
*** At close of year, after new financing during year.
**** Approximate.

Despite the fact that the figures must not be taken too seriously, certain observations can be made. Two trusts show turnover return exceeding interest and dividend income, in one case quite considerably, while another shows both approximately equal. The others all have a smaller turnover return. To what extent these represent established policies for the different trusts, remains to be seen. Undoubtedly some trusts that bought securities several years ago liquidated in the favorable markets of 1927, while those just entering the field may have neglected turnover through no disinclination of their own.

The sharp drop in the American stock market in the middle of 1928 caused much wonder as to the position in which investment trusts found themselves. The policy of liquidity pursued by leading trusts was already evident in the figures for the close of 1927 cited in previous sections. They apparently further liquidated a substantial part of their domestic security holdings early this year, increasing cash and call loans accordingly, or else favored foreign securities.[16] They were thus directly but little affected by the domestic situation, and were in a position to profit by picking up securities advantageously, meanwhile taking advantage of the high call rates. For the first time in nearly two years, they could buy high grade domestic securities to yield an average of not far from six per cent, instead of having to turn to foreign securities in order to get a return of that size. Some trusts were therefore getting into domestic issues affording better yields, which permit them to cover interest and preferred dividend requirements out of current income without recourse to trading profits, although others were still keeping out of the markets in the expectation of better buying opportunities later.

SPECIAL INVESTMENT DEVICES

The practical application of the investment principles has been well summarized by Robinson in his various writings under the head of factors to be considered in laying out trust funds.[17]

1. The age factor
2. The risk
3. The capital market
4. The credit cycle

[16] For example, on April 14, 1928 the Pacific Investing Corporation had 43.2% of total assets in cash and call loans, 17.5 per cent in bonds, 14.8% in preferred stock and 23.8 per cent in common stock, as contrasted with the figures for December 19, 1927 cited earlier in the chapter. An even more vivid illustration is afforded by the income report of the United States and Foreign Securities Corporation for the first six months of 1928. Interest and dividend receipts were $953,000, as compared with $898,000 a year before (more than sufficient to cover dividend requirements on first and second preferred stock), while turnover profits were $3,923,000 as compared with $537,000.

[17] See his book, pp. 107–117: also articles on The Complexity of Modern Investment Problems as Focussed in the Investment Trust, in

5. The international variation
6. The price spread

Each of these will be considered briefly.

The age factor has already been illustrated in considering the possibilities of carrying unseasoned securities through the seasoning process and introducing both foreign and domestic securities to the public. It represents, in fact, one application of the risk factor, since new and unfamiliar securities are apt to be undervalued by the market. The well managed investment trust, studying intrinsic values, can select such securities, as well as old issues selling "out of line," and on occasion defaulting securities when it possesses the requisite information. It can further avoid over valued savings bank and trustee legals and certain classes of "gilt edged" investments, whose prices have been raised to unwarranted and artificial levels.

Not only may individual securities be thus selected, but a basis can be afforded through study of the position of entire groups of securities. From approved groups, individual issues may then be chosen. Differences in risk and in capital supply cause differences in interest rates in different markets. Some present more favorable yields than others. Even the same security may at times be picked up on a better basis in one market than another, as has often been pointed out in discussing foreign dollar bond quotations in London and New York. Thus advantage may be taken of the capital market factor. Again, over a period of time, security prices in any one market change greatly in accordance with the so-called "business cycle." By paying careful attention to the changing behavior of bonds and stocks in different stages or phases of the cycle, many

The Magazine of Wall Street, January 1st, 1927, and Some Accounting Problems of Investment Trusts, in Journal of Accountancy, January, 1928, the latter reprinted in Keane, pp. 556 ff.

profit making opportunities arise. "In times of business prosperity rising interest rates often tend to depress bonds, though the greater safety of underlying assets, the larger earnings of the issues and the general buoyancy of the stock exchanges often exert a contrary force. Common stocks, on the other hand, enjoy a combination of influences, such as rising earnings, greater prospective profits, security and prevailing buoyant markets, which in the long run tend to outweigh any bearish factors of rising money rates and drive their prices upward. In times of business recession the contrary is the case and stocks tend to fall as bonds rise."[18]

Not only may the credit cycle factor be studied in one market, but advantage may be taken of the fact that at no one time are all countries in the same stage of the cycle. Security prices are thus comparatively high in some markets, which are to be avoided, while they are depressed in others, which offer favorable opportunities for purchase. Thus advantage may be taken of international variation. Finally, the price spread factor may be considered. We know but little as yet of the interrelationship obtaining between conditions in different industries, and the "lags" and "spreads" between them. We do know that issues in certain industries have distinct seasonal swings in prices and we do know that purchase of securities in depressed industries often yields larger returns, so that we have in effect a series of markets, exhibiting diverse tendencies, rather than a single unified one. While better understanding of these phenomena, as well as closer linking together

18 Robinson, reprinted in Keane, p. 560. As he points out in his book, p. 111, this study is important not merely if the trust wishes to redistribute investments upon a higher yield basis, but also "to evacuate an unsafe position to minimize a probable greater loss by accepting an immediate smaller one, to withdraw from issues expressed in fluctuating or falling currencies, or merely to obtain funds for acquiring promising new issues."

of countries, should tend to level out these differences in time, place and field, many discrepancies will continue to exist for a long time to come.

A concrete statement of the American Founders-International theory is given in the former's special report to the shareholders as of March 1st, 1926:

"In its methods of purchase and liquidation, the trust makes a distinct contribution to the theories and principles of investment trust administration, which it is believed may enable it and the trusts under its final supervision to surpass even the remarkable earnings of their British predecessors. Only securities of high grade are purchased, carefully selected under an eliminative process of effective statistical tests. Purchases are made only in depressed markets, chiefly on standing orders at fixed prices entered below the market. This system of buying necessitates continual analysis of many thousands of securities, and directs attention to depressed markets wherever they may occur throughout the world. Securities purchased are sold only when prices have advanced out of line with other eligible securities available in other markets. World markets are never all depressed or all buoyant at the same time, and conditions constantly change in all markets. The process of liquidation naturally occurs in buoyant markets. In such relatively rapid turnovers, the trust realizes considerable profits, even though it keeps its investments always of a similarly high quality.

"The trust has thus created a new technique of investment trust administration, the supplement the diversification and watchfulness practiced by British investment trusts."

In carrying out its purchases, the International group thus employs scale buying. Analysis of existing issues serves to fix prices at which they are attractive, as a rule below the market. Bids are made good until canceled for definite quantities at given prices, the number taken increasing as the price declines.[19] Similarly, sales may be made on a scale up, the amount liquidated increasing as the price rises. The Standard International, which makes no reference to scale buying, fixes a sale price at time of purchase, determined by the yield, *based on an anticipated market price,* which will show a return so far below the trust's requirements, that the part of the trust's funds, so employed in the particular security, *plus such profit,* can be more advantageously employed by re-investment.[20] A multitude of both buying and selling orders are thus outstanding at any one time. The International group use a similar income test for selling.

The Attorney General of the State of New York has taken a strong position against short selling by trusts, which he believes is rightly termed speculation.[21] He observes that British trusts scrupulously avoid short selling, while the International group directors have adopted resolutions forbidding the practice. A number of trusts—even more than bar margin trading—prohibit short selling.

UNDERWRITING

British trusts actively participate in underwriting syndicates. In part, this reflects the British method of security distribution, wherein underwriting agreements are often made through groups of companies or financiers, and the investment trusts constitute one of the important underwriting groups. The trusts are interested in more than their fee. They generally confine their underwritings to se-

[19] Robinson, p. 287.
[20] Burton, C. S. The Investment Trust. A Resumé. Its Adoption in the United States, p. 7.
[21] Survey, p. 79.

curities that they otherwise regard as desirable for their portfolio, and regard underwriting as incidental to investment operations. In other words, the underwriting becomes the means of buying a sound security at what amounts, owing to the underwriting fee and the wholesale buying price, to a considerable discount. If the new issue is especially attractive, it definitely reserves the amount for purchase; while if the underwriters have to act upon their agreement, it purchases its quota, generally without recourse to bank borrowing, and holds it at least throughout the probationary period, or pending an advantageous market.

The trusts obtain their underwritings either direct from the issuers, or else indirectly through an intermediary which acts on behalf of several trusts. Robert Fleming & Company arrange underwritings for the group of trusts closely associated with them, as do also certain leaders of other groups. They render a service akin in this respect to The British Trusts Association, Ltd. which body is, however, far more inclusive in its scope. Some Fleming trusts are members of the association, and receive underwritings from these two sources as well as direct. These intermediaries underwrite entire issues of securities.

Much misconception exists in the United States as to The British Trusts Association, Ltd. It is often regarded as a sort of trade association of British investment trusts, when in fact it is nothing of the sort. It has the far more modest object of providing underwritings for its members and, to a much smaller extent, a means for liquidating existing holdings. Because of its strength, it exercises great influence in underwriting many important issues. It started with twenty-one members, all investment trusts, and now has one hundred thirty-five shareholding trusts. Its issued share capital increased from £9,520 in 1917 to £212,000 in 1928. This capital it uses largely in temporary holding of securities. Its income it derives largely from commissions and underwriting profits, but it supplements these sources by interest and dividends on investments, trusteeship fees and realized profits on securities sold. It has paid on the average somewhat over eight per cent, minus income tax, on its ordinary stock, which is held by the member trusts, and thus represents a sort of cooperative enterprise or undertaking of British trusts in this one field.

American practice has generally opposed widespread participation in underwriting. In 1926 it was stated that "participation in underwriting syndicates [is] as yet alien to most American investment trusts." [22] The same is hardly true today, especially in the case of trusts affiliated with investment banking houses. Underwriting is generally stated in the charter as one of the objects, whether availed of or not. But few trusts would seem to be forbidden to engage in the practice, as in the case of the International Securities Corporation, which may take only seasoned and marketable securities. Nor are they limited as is the Second International Securities Corporation, which is specifically permitted only to "underwrite issues of securities eligible for purchase, to an amount not exceeding in any case twice the amount of such securities which could be purchased for investment, but in no case to an amount in excess of six per cent of total resources. The total liabilities incurred in underwriting shall not at any time exceed twenty per cent of the resources of the Corporation." The United States and British International Company, Ltd., sets maximum underwriting liability at one time at twenty-five per cent of the general funds.[23]

[22] Robinson, p. 96.
[23] Standard International Securities Corporation provides the same, but limits the total to twelve and one half per cent.

In addition, one step removed from underwriting, trusts secure concessions on blocks of new securities they purchase. The regular code is one fourth off to banks, insurance companies, etc. Banking houses often give them part of the spread between issue price to banking syndicate and price the general public pays, depending upon the extent to which they desire to make the sale or the opportunity of executing stock exchange orders. It is said that from all except leading houses a trust can get the full discount of the underwriting syndicate on a purchase of $25,000 or more.

Whether or not a trust should participate in underwritings, has often been discussed. Rightly conducted, it possesses obvious advantages in obtaining good securities on favorable terms, as well as adding to trust income. But it is susceptible of abuse in the hands of the unscrupulous. In the case of house trusts, it involves the entire question of relationship between the banker and the trust he sponsors. And British trusts must "play the game" by accepting the poor along with the better syndicate participations. Even where new securities are bought elsewhere, the securities are unseasoned. If the discount be standardized, well and good. But if attempt be made for maximum discount, poor securities may easily be gathered, and in the process of buying further disorganization of our securities marketing mechanism result.

SOME ECONOMIC EFFECTS OF INVESTMENT OPERATIONS

In addition to the usual economic results sketched in Chapter I, some more intricate and technical influences of the activities of investment trusts in foreign fields were recently suggested.[24] Before the war, there was comparatively little trading in the United States and other countries in foreign internal securities. Due to the clear cut distinction between borrowing and lending nations, only seldom did one creditor nation invest in the internal securities of another. On the other hand, the security markets of borrowing nations were not very well developed and not equipped to handle large amounts of foreign funds.

The war changed the situation radically. Lack of capital in former creditor nations caused their internal securities to become greatly undervalued. American banking houses and investment trusts, especially the latter, rather than individual investors, were in a position to take advantage of such investment opportunities. Up to about a year ago, the result of their purchases was merely to act as a stimulus in the foreign capital markets and to push market prices closer to intrinsic values. In many markets, price movements are determined to an appreciable extent by the flow of American capital. The rise in prices of foreign internal securities during the present year was generally credited principally to purchases by American investment trusts in anticipation of a drop in the prices of American securities. The result was to raise exchange rates of certain European countries beyond the gold export point for the dollar and cause gold to flow out from the United States.

These investment trust purchases and sale cause a new problem to confront the central banks. While the former operate in the capital market in the same manner as banks operate in the international money market, the banks use judicious discretion in placing their funds, as well as in withdrawing them, bearing in mind the possible effect of

[24] Madden, J. T., in The Journal of Commerce, July 6, 1928.

such operations both on the American and foreign markets. Investment trusts, instead, are interested primarily in the opportunities for profit which are presented to them. Foreign central banks have recognized the problem and, in contrast to securities offered publicly in foreign markets, regard foreign funds invested in internal securities as short term loans. They must be prepared to maintain the stability of their currencies when the liquidation of these securities will cause a return flow of funds, as it is likely to in the not distant future.

PUBLICATION OF HOLDINGS

Roughly half the British trusts today publish annual lists of their security holdings. Often these are not classified, hence analysis is difficult, but some print in addition summary classifications that exhibit principal tendencies, while others print only such summaries without disclosing the exact securities held. Some trusts have abandoned publication recently. Undoubtedly stockholders making the request in the proper manner can obtain the information in most cases. In the early years, American trusts at one time or another published either their holdings or a list of approved securities from among which purchases might be made. Today practice is no more uniform than in England. Some larger American trusts, especially with banking house affiliations, such as the United States and Foreign Securities Corporation and the Standard Investing Corporation, have followed the lead of the Bancitaly Corporation (not entirely an investment trust), which began publication in the summer of 1927. On the other hand, the American Founders group for years has published only summaries, and some trusts give out no information at all.

Whether or not holdings ought to be published, has been hotly debated. The objections voiced by various trusts may be stated as follows:[25] "Quoted"

1. The trust may be subject to criticism by ill-informed investors and may induce uneasiness on the part of holders of its securities, who exaggerate the influence of adverse security market, political, or other conditions.

2. The list make up is a valuable asset.[26] To disclose it gives data which investors may use in direct purchase of securities, brokers on behalf of their clients and competitive trusts.

3. The trust may find it difficult to accumulate a position in a security if a large public following is brought in before it has completed its accumulation. Conversely, it may be handicapped in realizing on its holdings if their extent is known.

4. As in the case of savings banks and other institutional investors that are required to publish lists, security dealers propose innumerable trades and the trust receives many inquiries on the position of particular securities that it holds.

5. The list quickly becomes antiquated and misleading.

6. In some trusts, it reveals the personal interests of directors and is held to be particularly objectionable in the case of financing companies.

7. For a trust with a banking house affiliation, failure to purchase a particular security will be interpreted by other clients of the house as indicating doubts in the minds of the bankers as to the worth of that security.

Despite pleas on these grounds that confidence be reposed in the management, particularly if it pursues an active turnover policy, publicity seems more desirable. Only by publishing a complete list of securities and amounts at

[25] Compare Robinson, pp. 88–89.
[26] Attorney General of the State of New York, Survey, p. 71.

both cost and market, can the quality of the portfolio be judged; while only by summaries—geographic, industrial and type of security—can diversification be analyzed. Furthermore, stockholders on application should be informed of changes. Otherwise, "blind pools" with all their possibilities of abuse, especially in a relatively new and untried movement, arise. The English experience of the early nineties constitutes a strong plea for publicity in the United States today.

THE INVESTMENT MECHANISM—BRITISH STYLE

British trusts, it has been seen, do little to hamper the management, in which they repose great confidence. Theirs is the investment responsibility. Interlocking directorates and joint management serve to conduct the relatively small individual trusts effectively and economically. This conduct is supplied in considerable measure by solicitors or writers to the signet and chartered accountants, especially in Scotland. "Their decisions are based more upon market opinion, published information and knowledge of personalities than upon any original investment analysis." [27] Scottish trusts, aside from a somewhat lower cost of operation, have evidently found quiet judgment and sense of proportion a valuable factor in management, despite the fact they are removed by a day's journey from London.

Directors of British companies receive regular compensation. They are often required to be substantial shareholders, for £1000 or more, and may have dealings with the trust in the absence of secret profits and misrepresentation. Their staff is small. The managing director receives additional remuneration. The secretary directs the routine

[27] Attorney General of the State of New York, Survey, p. 67.

operations and prepares security analysis for the directors at their meetings, for which he receives a regular salary. He often occupies a similar post in several trusts which have the same offices and is assisted by the necessary clerks. Auditors make periodical audits required by the Companies Acts. The administrative expense averages one half of one per cent per annum on the total paid-in capital, being somewhat lower for the Scottish than for the British trusts.[28] From one half to two thirds of this sum goes to the directors. Sometimes the directors receive a lump sum, in addition to the other expenses, but at other times the appropriation covers both directorial reward and operating expense. Sometimes brokerage, auditors' fees, legal expenses and taxes are separated from ordinary administrative expense.

Some disposition exists today to criticize British investment trust administration. The trust staffs are said to be too small for the greatest efficiency, especially where the directors receive the remainder of the appropriation after paying expenses. Too little reliance is placed on statistical data in investment analysis. As a result, the trusts tend to keep securities in their portfolio so long as they yield a good income, despite the fact that other opportunities exist for a higher yield. In short, more emphasis is placed upon keeping down administrative expense than upon providing an alert and efficient investment organization, and the investment operations are thereby handicapped.

[28] The (London) Financial Times percentages follow:

		Thirty London Companies	Twenty-four Scottish Companies
1927–8	Average	.46	.41
	Range	.23–1.74	.28–.62
1926–7	Average	.46	.41
	Range	.28–2.05	.29–.59

AMERICAN TRUST MANAGEMENT

No such criticism can be leveled against American trusts. In fact, in some cases at least, they tend to go to the other extreme. They often have a much more elaborate and formal organization. The American Founders Trust has furnished a model for formal corporations furnishing investment service to a number of trusts and has been followed in that particular by the United States Fiscal Corporation and the Investment Research Corporation.[29]

The American Founders Trust purchases securities for the portfolio of the affiliated companies upon order of the directors to whom it submits its recommendations, or for its own general holdings. Its organization is as follows:

Economics Department—studies the general situation of the investment market in each country under consideration, examining such factors as interest rates, investment levels, political conditions, commercial conditions, commodity values and foreign exchange rates. The economists follow important industries, both from a national and international standpoint.

Investment Department—narrows down the general reports of the Economics Department so that the possible effects of general conditions on specific securities can be gauged. A staff of analysts, specialized by territories, examine the individual securities and prepare recommendations for purchases and sales. They are divided into some seven geographic divisions. They keep elaborate security records on standard analysis cards for various classes of

[29] Its additional work is:

1. Investing substantially in the junior shares of trusts under its supervision.
2. Investing and reinvesting in marketable securities.
3. Underwriting investment securities.

securities, on which significant data are abstracted and digested.

Appraisal Division—makes monthly checks of holdings and when substantial appreciation or depreciation is noted, the security is examined for decision as to what action shall be taken.

Investment Committee of Board of Directors—passes upon recommendations and supporting statistical data, and transmits to the affiliated trusts. The effort is made to obtain careful balance between exhaustive research and mature investment judgment.

The Executive Committees of the Board of Directors of the affiliated trusts authorize the daily investment transactions and submit them for approval at the monthly meetings of the full board. All holdings are checked monthly for conformity with the investment regulations.

Instead of having this elaborate organization and formalized procedure, some trusts rely upon the security dealer with whom they are affiliated. The J. Henry Schroder Banking Corporation, for example, conducts the affairs of the Continental Securities Corporation, subject to the direction and approval of the latter's board of directors. Instead, a regular investment counsel may be employed, such as Edgar Higgins, Inc., or the Investors Council of America, or, as in the case of the Shawmut Bank Investment Trust, the executive committee of the bank may appoint the trustees or managers. Sometimes an advisory committee is used in place of, or in addition to, the others to "dress up" the picture, generally by less known trusts.

Compensation for investment service may be stated either as a percentage of earnings or as a percentage of capital. The former seems preferable, in that it proportions reward to performance, but the latter is usual. Among the former, the International pays Founders annually four per cent of gross earnings after taxes,[30] while the Continental Securities Corporation pays J. Henry Schroder five per cent of net income distributed to stockholders and five per cent of earned surplus if the contract is terminated. The Overseas for a similar service pays Scholle Brothers ten per cent of net profits and the directors in addition eight per cent, while several local trusts pay the sponsoring security dealer twenty per cent, out of which he pays expenses of operation. Where a percentage of resources instead is paid, one half of one per cent is usual. But the new United States and British International sets that figure only on resources in excess of $10,000,000 and for the first $10,000,000, after deducting its investment in its British subsidiary, sets three fourths of one per cent. From The American Capital Corporation the Investment Research Corporation gets four tenths of one per cent, while estimated total expense should not exceed six tenths of one per cent; the total figure for the Investment Company of America, it is said, will not exceed one half of one per cent, including such investment fee and operating expenses. Rarely, as in the case of the Financial Investing Company of New York, Ltd., is a dollar amount set. Some less known trusts instead limit trustee or director compensation, individually and in the aggregate. A number of trusts pay the directors nothing, and in some cases the latter even assume operating expenses up to a named figure during a certain initial period. Of course, the larger part, if not all, of their anticipated profit comes through the holding of junior stock and trading on the equity against the public, as explained in the preceding chapter, and the entire matter of cost of operation from the management's

[30] It was paid solely in options to purchase common stock prior to the reorganization.

point of view cannot be considered independently of the financial plan.

The Attorney General of the State of New York feels[31] that American expenses of trust operation have been somewhat higher than the British, but are more than compensated by larger turnover profits. For the International total expenses do not exceed seven tenths of one per cent on average invested capital, for the Second International nine tenths of one per cent. Expenses should decrease relatively with the size of the trust.

Finally, trust contacts abroad should be mentioned. Most probably have no definite foreign tie-up. A small number have definitive foreign banking affiliations, secured either through the coöperation of the foreign group in financing the trust,[32] or through the specific affiliations of the bankers here who are affiliated with the trust. To serve those trusts which have no definite foreign affiliations, especially in transactions in internal securities, a number of intermediaries have grown up. Several have offices in New York, which arrange for purchase and sale and safekeeping of securities bought for investment trust account, and also obtain discounts on new issues granted to financial institutions. Banks in several European countries, notably Belgium and Austria, have established branches in New York which do the same kind of business as these intermediaries. Most definite among all tie-ups is that between the American Founders Trust and Helbert Wagg & Co. of London, in connection with the United States and British Inter-

[31] Survey, p. 68.

[32] For example, the American, British & Continental Corporation has an advisory bankers committee, with central office in London, composed of a representative of each of the participating institutions. Its members propose investments, which J. Henry Schroder & Company transmit with their opinion to the board of directors for consideration.

national, formed in 1928. The new trust purchased for cash all (except directors' qualifying shares) of the £500,000 capital stock, initially issued for £506,250, of the Trans-Oceanic Trust, Ltd., of London, thus creating a British subsidiary. The latter will have its portfolio managed by Helbert Wagg & Company, Ltd., who now manage the portfolios of several British trusts, under the supervision and control of the trust's board of directors. All the class B shares of the United States and British International have been purchased for $1,000,000 in cash by American Founders Trust, Helbert Wagg & Company, Ltd., and certain other interests.

SELECTED REFERENCES

Fowler, Ch. VIII. Further Analysis of the Portfolio, pp. 110–122; Ch. IX. Investment Restrictions, pp. 123–135; Ch. X. Management of the Portfolio, pp. 136–146; Ch. XI. Management of the Portfolio—Continued, pp. 147–156; pp. 172–178.

Grayson, pp. 51–57; Ch. VI. Methods of Investment, pp. 77–88; Ch. VIII. Management, pp. 98–107; Ch. XIV. Management of Trust Securities, pp. 177–213.

Robinson, Ch. V. Management of the Portfolio, pp. 80–101; Ch. VI. Management of the Portfolio (cont'd), pp. 102–123; pp. 282–290.

Speaker, pp. 29–30, 37–57.

Williams, Ch. IV, Operation and Management, pp. 27–39; Ch. VI, Qualifications, pp. 48–54; pp. 82–87; Appendix A, Portfolios of Investment Trusts, pp. 97–129.

Attorney General of the State of New York, Survey, pp. 33–34, 56–57, 67–79.

Davies, A. E. Investments Abroad, Chicago & New York, 1927. Ch. XIV, Investment Trusts, pp. 158–184.

Robinson, L. R. Some Accounting Problems of Investment Trusts. An address delivered before the Society of Certified Public Accountants of the State of New Jersey, at Newark, Nov. 22, 1927. Journal of Accountancy, Jan. 1928, reprinted in Keane, pp. 556–561.

——, The Complexity of Modern Investment Problems as Focussed in the Investment Trust. The Magazine of Wall Street, Jan. 1, 1927, pp. 4.

The International Securities Trust of America, 1921–1926. Five Years of Growth and Progress, pp. 26.

Investment Trust Policies. Methods Behind Rapid Growth of the International Securities Trust. Barron's, Aug. 30, 1926 (also useful for Ch. VII).

Van Riper, W. American Investment Trusts. Their Possibilities and An Outline of the Requisite Policies, Barron's, May 24, 1926.

CHAPTER VII

CORPORATE TYPE TRUSTS—INCOME AND ITS DISTRIBUTION

The income of an investment trust is not derived from the same sources as is the income of an ordinary corporation. The latter purchases merchandise for later resale, perhaps after subjection to certain manufacturing processes. It expects that the gross profit on the turnover will so far exceed the costs of operation as to leave a net profit for the common stockholders after paying a fixed rent, in the form of bond interest and preferred dividends, for the capital, if any, they may have obtained from bondholders and preferred stockholders. In addition to these current assets, the ordinary corporation may possess a greater or lesser amount of fixed assets representing plant and similar items.

On the other hand, the investment trust has its funds laid out primarily in securities and cash, which it holds as long as it chooses. It derives (1) a current investment income from interest and dividends it receives on securities it holds. In addition, as it changes the securities in its portfolio, it may obtain (2) turnover profits—or losses—in other words, realized capital gains or losses, on securities sold. Meanwhile, the current position of its portfolio may change, for the securities which it continues to hold may either increase or decrease in value, and involve (3) either unrealized capital gains or losses. Finally, it may have (4) miscellaneous sources of income, such as underwriting fees and trusteeship,[1] secretarial and registration fees. How to record the resulting changes in the trust's condition from time to time, and which of the items to regard as representing income available for payment of dividends, presents a several fold problem. It involves law and taxation, accounting and finance, in the balance sheet as well as the income statement.

The task does not arise in considering current investment income, whether consisting of interest or dividends, which presents no special problem. Nor does miscellaneous income. But British practice with respect to treatment of turnover profits differs sharply from American and considerable controversy has resulted. The British hold that one of the cardinal characteristics of the investment trust —in addition to the capital structure and investment policy already mentioned—is that turnover profits are not treated as current income and that dividends are paid only from interest, dividends and miscellaneous income received. American trusts differ in their attitude towards such realized capital gains, and this difference, as was pointed out in the last chapter, has had direct relation to their respective investment policies.

The British theory regards the trust as starting with a certain amount of capital. This is permanently to be kept in the enterprise, which is concerned with maintaining the integrity of that capital and, at the same time, affording the investor an adequate return thereon. Hence changes in the capital itself are of slight moment, unless they be such as seriously to impair it. Conservatism dictates that it be stated at a minimum figure, never in excess of the actual value in the market; and so it is, unless there be a collapse in security values, such as occurred after 1920. Any ac-

[1] Private estate trusteeships are not accepted by British trusts. Underwriting fees alone are, of course, available to American trusts.

cretions through turnover are better not flaunted to the public gaze, but used instead to strengthen the trust's position. They are part of the fund, and by retaining them the stated capital account will be steadied, while net income from investment remains available for distribution. Thus the British attitude affects the treatment of both turnover profits and valuation of assets. The result is a more conservative, though a less accurate picture. The balance sheet becomes arbitrary, unrelated to either cost or market value of securities held; while the income account is a torso. Yet the practice measurably strengthens the trust in an unknown degree and provides a basis for steady growth in income and hence in dividends as principal is built up.[2]

TREATMENT OF TURNOVER PROFITS

British trusts almost universally do not show their realized capital gains in their income accounts. Where they do, they show the item and its disposition short, and do not take it into the accounts. They use it chiefly in writing down the book cost of investments, partly in meeting the expense of new issues. In the balance sheet, as noted, they do not show the sum separately, but merely a net figure after such writing down. They refuse to regard turnover profits as a source of income, hence available for distribution as dividends, but insist upon their reinvestment.

One circumstance which has contributed to maintenance of this practice has been taxation. In recognition of the custom which had grown up, investment trusts are permitted by the Internal Revenue Authorities of the United Kingdom to deduct profits on turnover from their taxable

[2] In one sense, we have in the problem of how to treat turnover profits one phase of the celebrated economic problem of how to distinguish between capital and income.

income. On the other hand, Scottish trusts prior to 1923–4 were required to report capital gains, but permitted to deduct capital losses. This practice was more favorable during the early post-war years of heavy security depreciation, whereas the established practice was more favorable during the previous long period of rising prices accompanied by considerable profits on security sales. A majority of the older Scottish trusts and all the new British ones have adopted the standard practice, and the Scottish companies, while they formerly showed these earnings as an item in their accounts, did not treat them differently.

In the United States, trusts regard realized capital gains as part of income and pay dividends therefrom.[3] The question arises, is the British practice or the American preferable? Adoption of the one system by the other is largely an academic question. British practice has thoroughly crystallized and has the force of tradition. American trusts, on their part, constructed as they are, can hardly undertake to follow the British method; they need the capital gains to make a showing and make their common stock of real value. In explanation, it is said that under the Federal tax law, they are required to report realized profits as income and, it has been urged,[4] bank precedent in the United States favors such a practice.

Another basis that can be indicated for the practice—aside from the necessities of the situation—is the fact that American corporations in general are much less liberal

[3] Only one exception comes to mind. The stockholders of the Standard International Securities Corporation, at a special meeting held August 15, 1928, voted to set aside profits realized from sale of securities in an "investment and preferred stock dividend reserve," until the latter equals three times annual preferred dividend requirements. All interest and dividends on securities held are to be distributed to stockholders each year. And this is a very limited exception indeed.

[4] Attorney General of the State of New York, Survey, p. 88.

in their dividend policies than are British corporations. They pay out a smaller proportion of their total income as dividends to stockholders, using the remainder to accumulate substantial surplus and reserves. Insofar as American trusts hold only stocks of American enterprises, and British only stocks of British concerns, American trusts might be regarded as giving over in part to the concerns whose securities they hold the task of accumulating reserves, while British trusts are forced to accumulate the reserves themselves. But both British and American trusts often tend to roam the world in search of investments, while both furthermore often hold a considerable proportion of their assets in bonds instead of in stocks, for which such reserve accumulation by the underlying companies would be more remote. Hence the explanation possesses but limited significance and validity.

Leaving aside the basic relation of the difference in trust practice to the entire attitude towards investment trusts prevailing in the two countries, the difference itself is further one of the emphasis placed upon current yield as contrasted with future growth. Enough must, of course, be ploughed back to make the trust safe, and this is apt to absorb the bulk of the earnings, but, beyond that point, some investors prefer appreciation, others current income.

There is no doubt that the emphasis on turnover profit in the United States served to attract hosts of investors and put the trusts in receipt of ample capital,—more so than would have been possible by any other means. Recognition must be given the earlier post-war trusts for their acumen in perceiving the great upward swing in security prices which was to take place and their seizure upon it as a basis for their operations. Yet, from another point of view, the question may well be raised whether this course was wisest in the long run. It serves to arouse great expectations, yet can turnover profits, in sufficient volume, be counted upon with sufficient regularity? Will future investment conditions, admittedly less favorable than those of the past six years, provide adequate opportunity? And, if not, has not the whole investment trust structure in this country been reared upon shifting sands, rather than upon a firm foundation?

VALUATION OF INVESTMENTS

In constructing the balance sheet, it is necessary to consider the relation obtaining between cost price and current market value of investments. In other words, what attitude should be taken towards unrealized capital gains or losses?

Since the portfolio is not a "stock in trade" and the trust is not forced to liquidate at any set time, current market value is not as important as for the mercantile or industrial enterprise. Theoretically, price changes due to temporary general market swings of security prices may be disregarded. Depressed markets do not affect current income, while they afford buying opportunities with such funds as are available.[5] On the other hand, changes in the intrinsic value of individual issues, either up or down, seem important, but in a widely diversified list, tend to offset one another. Practically, however, these two classes of price changes cannot be distinguished. To avoid overstatement of position, unrealized capital gains should be registered only in the event that a stock dividend based thereon is to be declared. Conversely, unrealized losses only if capital or reserves are to be cut to permit radical downward readjustment. Robinson therefore concludes that "balance sheet figures for securities held by investment trusts should

[5] This was evident following 1920 when many British trusts stated in reports to shareholders that substantial book depreciation existed.

not be higher than actual cost, and need not necessarily be as low as current market quotations. The extent, if at all, to which they should be below actual cost in case of unusual depreciation, ordinarily depends upon the policies of reserve accumulation followed by the trust.''[6]

American trusts generally carry their portfolio at cost. British trusts generally show a substantial understatement in their ''at cost or under'' figures. Not only do they write off all securities that ''go wrong,'' some of which may later be salvaged, but they also build up what is really a concealed reserve in the form of a ''contingent fund'' or ''suspense account for adjusting the value of securities,'' used ''to write down cost of investments,'' into which go all gains realized on turnover and occasionally a part of the annual pure investment income.[7] They ordinarily do not show this figure separately, but merely show a figure for investments after deducting this contingent fund. The result is of course to give British trusts a double line of defense in the event of an adverse market situation—reserves corresponding to American reserves and surplus which appear in the balance sheet and, in addition, an inner or concealed reserve of unknown size. The International Securities Corporation of America and perhaps one or two others are the only ones which have as yet made such appropriation to hidden reserves.[8]

Actually, it is desirable to have the balance sheet show, in a note, the figure for current market value of investments, which can be compared with the figure used in computing assets or with the cost. This should increase public confidence, at the same time that it exercises a restraining influence upon the management. In addition to annual or

[6] P. 129.

[7] In other words, they reinvest these sums at compound interest to build up principal.

[8] Robinson, in Keane, p. 562.

semi-annual inventories made by auditors, periodical appraisals within the organization, say monthly, of liquidation values are desirable for the use of officers and directors. Of course this is far different from showing in an income account, unrealized capital gains, even though it is separated from other sources of income, and then added into "total income." And it does not condone the practice of one Canadian trust, as stated naïvely by its directors, that in order to have the balance sheet reflect more accurately the actual condition of the trust, they had sold certain of its holdings (that is, shown realized capital gains) and then immediately bought them back again.

PAYMENT OF DIVIDENDS WHEN CAPITAL IS IMPAIRED

A related question is this: should dividends be paid by an investment trust while its capital is impaired? Especially does this apply to dividends on the common stock.

British investment trusts for more than a quarter of a century have been permitted to do so. The sanction is found in the Lee v. Neuchatal series of decisions of the earlier Court of Appeal (Supreme Court of Judicature).[9] The second of these, the Verner case, in which the defendant was a trust, represented a friendly action by a stockholder who wished to ascertain whether such a company could continue to pay dividends when the investment had depreciated below the par value of the stock. The Lord Justices affirmed an earlier decision permitting the practice. The trust, in contrast to financing companies, might regard its holdings of securities as fixed assets, and while it must retain sufficient assets to meet all ordinary liabil-

[9] Lee v. Neuchatel Co., 41 C. D. 1; Verner v. General Commercial Trust (1894), 2 chapter 268; and Wilmer v. Macnamara (1895), 2 chapter 245.

ities, it need not make good depreciation on fixed assets. The decision reflects the British distinction between capital and income, stated in connection with turnover profits, noted at the opening of the chapter.

In a time like the post-war period, with its heavy depreciation of general security values in face of steady or mounting income, advantage is taken of this decision. Thus in 1920 the Investment Trust Corporation and the Metropolitan Trust Company both paid an increased dividend despite a depreciation on book cost of about seven and five per cent respectively. In 1921, values fell further, until they were twelve and eleven per cent below, respectively, yet both companies further raised their dividends by one per cent, paying fourteen per cent on their ordinary shares in each case. Values subsequently rose and have continued to do so, while dividends paid have also gradually increased.

General American corporate practice bans payment of dividends when capital is impaired. As yet, the trusts are too new and they have been operating in a boom period of security prices, so that they have not faced the problem. Instead, both the older, with their extensive financing from time to time, and the newer have been busy wiping out the intangible asset of deferred charges consisting of unamortized bond discount and / or organization expense, not covered to date by surplus. Of the larger trusts, practically none, except the International, have been on a common-dividend paying basis.

INVESTMENT TRUST VERSUS FINANCING COMPANY ACCOUNTING PRACTICE

British financing companies, in contrast to investment trusts, treat realized capital gains as income, in addition to interest and dividends. One of their chief purposes is to obtain such gains. They are therefore taxable on these gains as part of current income, and are permitted to deduct capital losses. Consequently, they often allow in their profit and loss statements for shrinkage in the market prices of the securities they hold, or vice versa. They are expected to make such allowance, not merely to state in the annual meeting or the auditor's report, as an investment trust would, that market value of the portfolio is somewhat less than cost minus the contingent fund (though probably with a decrease in the dividend rate).

In treatment of turnover profits, British financing companies therefore approximate American investment trust practice. But in the matter of valuation of assets, the American trusts pursue a middle course—not so conservative as the British trusts, but more conservative than the British financing companies.

Further illustrative of their conservatism are several other practices of British investment trusts. They have come to prepare their balance sheets on a purely cash basis and disregard accrued interest and dividends, even though reasonably certain. This avoids the necessity of a double burden on one year's income if a security defaults, through foregoing interest during the year of default and writing off the interest credited to accrued income at the close of the previous year. Again, when an underwriting participation is taken up, the commission is used to reduce the cost of the investment. Finally, a large trust may use a dividend payable shortly after purchase to write down the price of the stock, instead of treating it as current income.

Several American trusts have provided for a check by the shareholders on the trust. The International Securities Trust of America had a security holders' examining committee of three, which reported to the trustees early in

1927. The Standard International Securities Corporation in its August, 1928 changes proposes an auditor, to be appointed by the shareholders and to report directly to them, at least once a year, his recommendations, criticisms or objections, as the case may be. But such provisions are rare.

BRITISH RESERVE AND DIVIDEND POLICIES

Having discussed various phases of the question of determining what income is, we consider next how it is distributed. Either it is retained in the trust, or else paid out to shareholders. Since neither feature can be discussed adequately without the other, British practice as to accumulation of reserves and payment of dividends will first be taken up separately, and then the American.

British trusts usually build up but a single reserve and do not have the bond interest and preferred dividend reserves which some American trusts have devised, which are described in the last chapter. From the accompanying table, taken from those prepared by the (London) Financial Times, it is evident in the first place that combined debenture interest and preference dividends take less than half the earnings, both for English and for Scottish trusts. The latter have a thinner section of ordinary shares (19.8% for 1927–8, as compared with 28.0% of total capital for the former), hence the amount available for their ordinary shares is naturally greater than that shown by the English. A very wide range is, however, shown in each case among the figures for the individual trusts, and the same is true for all other items also. The English pay out but a slightly greater percentage of the sum available in common dividends—76% as against 73%, but both by thus setting aside about one fourth the sum available to reserve help the trust progress towards higher dividend basis. The Scottish trusts with their higher per share amounts available make a much larger per share contribution to reserves—4.79% as against 3.18%. While the Scottish trusts have the thinner common stock, this is offset by the total reserves and carry forward they have accumulated—107.05% of ordinary shares, as contrasted with less than half as much, or only 52.83%, by the English trusts.

	Thirty London Companies		Twenty-four Scottish Companies	
	1927–8	1926–7	1927–8	1926–7
Debenture interest, preference dividends, etc. less tax	£1,812,377	£1,696,221	£1,396,861	£1,158,589
Available for ordinary shares	2,681,499	2,407,355	1,597,955	1,485,798
Percentage — average —net	13.47	11.56	17.67	16.63
range	5.85–35.21	5.19–37.70	10.90–36.34	10.47–40.99
Amount paid	2,048,321	1,826,266	1,164,308	1,049,165
Percentage — average —net	10.29	8.77	12.88	11.74
range	5½–20	5–20	8–25	7–25
Surplus for year	633,178	581,089	433,647	436,633
Percentage — average —net	3.18	2.79	4.79	4.89
range	.35–15.21	.19–17.70	2.90–11.42	2.08–15.99
Reserves and carry forward	10,520,574	10,028,918	9,678,607	8,045,231
Percentage — average	52.83	48.14	107.05	90.03
range	.44–156.43	.63–165.11	10.97–261.11	7.48–240.92
Ordinary share capital	19,903,215	20,832,485	9,041,356	8,936,356

British trusts pay lower "interim" dividends at some time during the fiscal year and higher "final" dividends at its close. They are stated either as a named percentage of the outstanding common stock, or else as an annual percentage thereon, over the portion of the fiscal year covered by the dividend, usually six months. In their general dividend policy, however, two divergent lines are noted. Some trusts increase the rate as occasion offers, building up reserves meanwhile. In four of the Fleming trusts the reserve and carry forward is now 232.88, 178.62, 160.24, and 96.44 per cent of the ordinary shares, while they pay respectively 25, 21, 19 and 19 per cent on the latter. As contrasted with this policy, some trusts, instead, when the rate has reached a certain point, such as ten per cent, do not increase it further, but accumulate reserves until they are in a position to declare a stock dividend. The Lord St. Davids trusts have tended to do this in recent years, paying some ten per cent bonus on ordinary shares in preference, preference and ordinary or ordinary shares only, according to the trust in question.

In addition to the steady increase in the dividend rates of most trusts, and the occasional stock bonus in some, have been subscription rights. Again, in other cases, capital structure has been modified to the shareholders' benefit. Thus the Second Scottish American Trust Company substituted for the £400,000 of ordinary shares it had outstanding a year ago (it had no preference) £240,000 of preference and £160,000 of ordinary shares. The result was that, while the per cent earned on capital decreased slightly, from 8.79% to 8.73%, the amount available for the ordinary shares was more than doubled, from 15.80% per share to 34.29%, the dividend paid increased correspondingly from 11½% to 24%, the surplus for the year from 4.30% to 10.29% and the reserve and carry forward from 53.23% to 138.08%, despite an actual increase of only some £8,000 to £220,930 in all. A similar operation was that of the Scottish American Investment Company, Limited, in 1924, which divided the ordinary shares into two groups called A and B.[10] In neither case were actual dividends paid affected greatly, but holdings were enhanced greatly in selling value.

AMERICAN RESERVE AND DIVIDEND POLICIES

Discussion of American policies can hardly be as thoroughgoing as discussion of British, due to the newness of American trusts in general. Rarely do they pay common dividends; instead, they seem more concerned with building up values behind the common stock and wiping out the intangible assets of unamortized bond discount and organization expense. Comparison with British records can hardly be made easily, for British trust earnings as reported represent gross earnings after income tax, which include also small amounts of earnings from other sources, while American earnings are usually stated as gross before taxes. A percentage of investment income to capital employed is of little value, too, since British balance sheet values understate the actual portfolio greatly. And the British do not show turnover profits.

The accompanying table gives data for leading American trusts for the last fiscal year.[11] It should be read in conjunction with the table on page 164. In many cases, it should be borne in mind, substantial financing occurred during the year, so that bond interest and preferred dividends represent actual amounts paid, not requirements now existing. The general lack of common dividends has already

[10] Described in Robinson, pp. 169–71.

[11] The California supervisory authorities, in their eighteenth rule, require 10 per cent of profits to be set aside for surplus or reserve, until the latter equals 25 per cent of the paid-up capital stock or amount of that trust, unless the accumulation of a surplus, by the express provision of law, would cause to invoke a penalty. Keane, pp. 806–807.

been remarked. A further feature is the fact that interest and dividends paid in every case absorb by far the larger part of current investment income. Unlike the British, the American trusts pay out the greater part of their current investment income in charges on senior securities and rely very largely upon turnover profits for common dividends and additions to surplus. Unless they included these profits in income, their capital structure would at once be called into question.

	Bond interest etc.	Preferred Dividends	Common Dividends	Surplus
United States & Foreign	–	$1,602,178	–	$1,385,127
General American (11 mos.)	$322,917	77,500	–	1,085,555
American British & Continental	295,780	697,092	–	313,480
Standard Investing	242,187	45,000	–	253,223
Pacific Investing	45,701 ***	186,251	–	435,009
Allied International	24,244 *	47,745	–	38,131
First Federal Foreign	75,365	–	$129,593	110,339
Shawmut Bank	284,493	–	–	165,564 **
Old Colony	230,625	55,167	–	94,704 **
Mutual	1,863 *	18,067		790 ****

* Interest on secured loans.

** Before deduction of non-recurring net charges incurred in connection with formation of trust.

*** Includes amortization. Total earned income for the full fiscal year $747,864, as compared with $203,156 for the 8 months.

**** Company reports $14,284, of which the remaining $13,-494 represents unrealized capital gains.

Some further evidence exists in the case of the International and the American Founders, both of which have had a history extending over several years. The rapid growth of both has been already observed.[12] The International has pursued the policy of paying gradually increasing cash dividends, while putting substantial sums (derived largely from turnover profits) into the interest and preferred dividend reserves and into surplus, and then on two occasions capitalizing the latter by splitting the stock three for one. From organization up to June 1, 1926, it stated that only 30.6% of net earnings were paid out in common stock dividends, 18.4% set aside for bond interest reserve fund, 10.2% for preferred share dividend reserve fund, and the remaining 40.8% carried to surplus. The change in the form of the trust in 1926 to a corporation changed the remuneration of the American Founders Trust from options to purchase International stock at a fixed figure into outright purchase for cash of the entire class B common. The International's record has been as follows:

	Years Ended November 30th			Inception to Nov. 30,
	1927	1926	1925	1924
Income	$4,105,681	$2,262,347	$431,356	
Interest charges	596,845	364,018	97,026	
Balance	2,820,008	1,630,068	278,242	
Preferred Dividends	944,702	349,723	48,594	
Balance	1,875,306	1,280,344	229,648	$52,378
Bond interest reserve	117,464	244,510	41,787	
Preferred dividend reserve	219,730	129,479	22,869	
Balance	1,538,112	906,355	164,992	
Class A dividends	595,560	266,736	91,764	26,330
Class B dividends	150,000	—	—	
Surplus	792,552	639,619	73,228	26,047 *
Capital surplus	460,456	152,402		
Earned surplus	1,352,965	685,413		
Class A common	5,725,050	3,376,058		
Class B common	2,222,220	—		
Common stock subscription	—	2,261,251		

* Surplus and reserves.

12 Pp. 52 ff.

This shows a continued strengthening of position, yet the dependence upon turnover profits is perhaps most vividly shown by recalling that imputed turnover profits for 1927, after allowing 6½% on average portfolio held as interest and dividend income, were $1,941,084, which was but slightly larger than the balance of $1,875,306 remaining after payment of preferred dividends.[13]

The American Founders Trust at first paid cash dividends—$1.75 in 1922, 4.37½ in 1923 and .77½ in the spring of 1924. It then undertook to conserve its cash, evidently for use as the International expanded, and only reinstituted cash dividends in 1928. From August 1, 1924 it paid a quarterly dividend of 1/70th of a share in stock. Already in December, 1923, it had in effect declared a 400% stock dividend (through exchange of one share of $25.00 par for 5 no par shares), and later in both May, 1925 and February, 1926, declared a 200% stock dividend. Evidently it was capitalizing its earnings, both cash and especially book surplus, as its holdings of International and later Second International stock increased in value. In October, 1927, it offered its preferred and common shareholders rights to subscribe to 1/6th of the International class B stock it held. In February, 1928 it reinstituted quarterly cash dividends of twenty-five cents per share, continuing a stock dividend half as large as previously, or 1/40th of a share quarterly. It reported cash income of $2,829,093 in 1927, of which $2,006,123 remained after expenses and taxes, as against $543,960 required for preferred dividends, $145,675 of the balance going to preferred dividend reserve and the remainder or $1,316,488 to surplus. The year before its cash income was $1,277,280,

[13] This is confirmed by the following quotation from the trust's annual report for that year: "Income from interest and dividends was in excess of requirements for taxes, expenses, interest charges and Preferred dividends."

or $792,673 available to meet the preferred dividends of $285,346, leaving $250,583 for reserve and $256,744 for surplus. In 1925 the trust earned only $153,337.

The Attorney General of the State of New York states the theory underlying the Founders dividend policy as follows:[14]

"Whereas legally it would be poor policy to declare cash dividends against increased values, the payment of share dividends against increases in value regarded as permanent, enables the stockholders to share in the prosperity of the Trust without the necessity of selling such assets in order to create the cash profits which would be necessary for cash dividends."

Due to the peculiar nature of this trust, we can hardly characterize the policy as a mere distribution of unrealized capital gains.

MARKET PRICES OF TRUST SECURITIES

British trust tabulations of the (London) Financial Times as of June 1928 showed the following yields on the different classes of securities:

	Thirty London Companies		Twenty-four Scottish Companies	
	usual	range	usual	range
Debentures		5.06–5.73	5¼	5.13–5.38
Preference		5.14–6.21	5½	5.13–5.62
Ordinary	5–5½	4.01–6.09		3.48–5.60

Current market prices on London debentures and preference shares were regarded as somewhat below their intrinsic value. Yields on Scottish trust ordinary shares were below the yield on either debenture or preference shares,

[14] Survey, p. 93.

and they, as well as London ordinary shares, discounted to some extent probable increases in dividend rates and benefits from possible bonuses and capital appreciation.

American investment trust securities do not as yet constitute a homogeneous group, with recognized standard yield bases. Market prices of trust common stocks have been subject to considerable running up, as well as later drop, this year. The figures presented earlier[15] show a sharper rise up to mid-year, for almost all leading corporate trusts, than does the Dow Jones industrial average. Evidently the stability which a diversified investment list should bring is easily overborne in practice by the speculative hopes of the community, which may push prices to levels viewed with disfavor by the trust managers.

Another test of price levels is in relation to per share earnings and tangible book value. This is extremely difficult to make, due to the short periods for which data are available, the extent of new financing during the year and the possibility of misleading comparison due to misunderstanding of the data. The following are the approximate figures for some leading trusts:[16]

	Quotation August 1, 1928	Earnings per share 1927	Book value per share (Close of 1927)
Second International	49–55	2.88	17.37 *
Financial Investing Co.	26¼–28¼	1.80	12.59 **
First Federal Foreign	103	10.56	105.49
Standard Investing	35–38	2.98	1.52
General American	58 7/8	5.42 (11 mos.)	5.70
Continental Securities	113–118	9.81	59.30
United States & Foreign	24 7/8	1.38	6.67 ***

* Before new financing.
** As of April 30, 1928 $14.64.
*** Allowing for second preferred at $100 per share.

15 Pp. 68–69. See also pp. 254–255.

16 Earnings taken from tabulation of Grover O'Neill & Co., entitled American Investment Trusts, 1927.

These quotations are in every case well below the peak prices. The more conservative are priced at roughly ten times 1927 earnings, which include turnover profits,[17] while some are even priced at almost twenty times—rather a liberal appraisal of managerial capability, present and prospective. The varying book values reflect, of course, the different financial plans employed. Fowler suggests that the management be appraised at from 33% to 50% of the total invested capital in judging the market prices of trust stock.[18]

SELECTED REFERENCES

Fowler, Ch. XII. Accounting Procedure, pp. 157–167; pp. 168–172; pp. 216–222.
Grayson, pp. 65–76; Ch. VII, Earnings, pp. 89–97.
Robinson, Ch. VII, Accounting Problems, pp. 124–42; Ch. VIII, Accounting Problems, (Continued), pp. 143–157; Ch. IX, Earnings of Investment Trusts, pp. 158–73; Ch. X, Earnings of Investment Trusts (Continued), pp. 174–186.
Williams, Ch. V, Earnings and Dividings, pp. 40–47; pp. 87–88; Appendix C, following p. 154, Table of Earnings, copyright 1928 by Grover O'Neill and Co.
Attorney General of the State of New York, Survey, pp. 81–93.
Hamilton, Daniel. United States Fiscal Corporation's Investment Trust Ratings. 1928, p. 43.
Robinson, L. R., Some Accounting Problems of Investment Trusts. An address delivered before the Society of Certified Public Accountants of the State of New Jersey, at Newark, Nov. 22, 1927. Journal of Accountancy, Jan., 1928, reprinted in Keane, pp. 561–565.

[17] Current earnings, of course, are higher in some cases, notably the United States and Foreign.

[18] Pp. 219–222. Add the percentage to total invested capital, subtract bonds and preferred, and divide by number of shares of common.

CHAPTER VIII

FUND PARTICIPATIONS

Fund participations are to be contrasted with corporate trusts. For sake of convenience, such fund participations may be divided into two groups—those in which an initial list of securities is named, whether fixed or subject to change, and those in which no such list is provided. The present chapter deals with the second of these groups, while fixed trusts are treated in Chapter IX and managed list trusts in Chapter X.

In general, while the group of trusts here treated is by no means completely homogeneous, it possesses certain distinguishing characteristics. A single class of participation in the fund is sold, rather than several classes, as in a corporate trust. The fund is often held by a depositary or trustee, both for convenience and to reassure investors. The investor can come in at any time, paying a price based on the break-up value of the fund at the moment, and, conversely, he can make his exit at any time by turning his participation back to the trust and receiving cash therefor. The capital is raised cheaply and often outside, rather than by means of, ordinary security distribution channels. The management receives a fee, generally small, for its service, and does not seek to make a substantial return by trading on the equity. Some of these trusts vest almost complete discretion in the management, but others have added restrictions of various kinds, both as to investment and as to distribution of income. The investment policy generally envisages a more limited range of securities than does the corporate trust, often with principal if not sole emphasis upon common stocks. Accounting is made periodically—annually if not oftener—to the participants by the management for the stewardship vested in it.

BROKERAGE HOUSE ACCOUNTS

Various securities houses have had discretionary accounts, operated by the house, in which they sell their customers participations. The customer who does not wish to choose his own securities may join his funds with those of other customers of like mind, in a fund which the house will use in such investment and trading operations as it deems best. The customer "buys in" at a price based on the break-up value of the fund, and shares profits with the house according to the scale the latter sets.

The result is an investment trust of an informal sort, which looks in considerable measure to trading operations. The thought is, of course, to give the individual the advantage of house contacts and skill in a way hardly possible unless it be given entire discretion, and not as satisfactory when applied to smaller individual sums as to a substantial aggregate amount. A number of such security house accounts have "graduated" into regular trusts with a formal structure.

Often a somewhat similar plan has been advocated for the benefit of certain groups of investors believed peculiarly unable to handle their own funds themselves. In the spring of 1926, a Columbia University Investment Fund was actively discussed for the use of the faculty of that institution. In the same year, The Amalgamated Bank of New York organized Amalgamated Investors, Inc., to sell investment certificates to the Amalgamated Clothing Workers of America and its local unions, other labor organizations and individuals. In both cases the thought was to create a fund, operated under simple and easily understandable rules, at a low fee of an "investment counsel" nature, for the benefit of the group in question.

STRUCTURE

Funds of a formal sort, it was seen in Chapter IV, may be created in one of several ways. These were:

1. a. By trustees who issue their certificates to investors, or b. By a corporation which issues only common stock that it sells to investors.

2. By a concern which manages the fund, under indenture with a trust company which holds the securities, etc., comprised in the fund. Here the trust instrument defines the relations between investors and managers, and the investor buys certificates of participation in the fund. The managing concern may create and manage several funds, while in any case a bank or trust company may act as custodian of the securities.

In all these forms, the salient feature is that a number of individuals band together in a common fund, all on an equal basis. There is merely one class of participation, not several. Thus the participants lose the advantage which comes from trading on their equity against senior security holders,[1] whom they may pay a fixed rate for the use of such funds, less than the rate which the funds can earn when invested. At the same time, the participants have a

[1] A few funds, however, specifically permit borrowing, with pledge of assets, for example up to 25%, 40%, 66⅔% or 100% of the fund. To date, this has been used chiefly to obtain call loans of moderate amount.

stronger position as a result of their sacrifice. But the plan is advocated chiefly as a measure of justice to investors.[2] British trusts, it is said, have succeeded in such a degree as they have largely because they were able to borrow such large sums in perpetuity years ago at very low rates of interest. Hence some of the participants in a British trust —namely the ordinary shareholders—have benefited at the expense of the others, in particular the debenture holders. And some of the plans, at least, stress the speculative attribute of bonds and preferred stocks in connection with changes in the general price level and the general level of interest rates, hence oppose their use.

Difference in legal form is of little further significance.[3] The Alexander Fund, in fact, is even entirely informal, the situation being that of an agency, in which the participants are clients and the manager an agent whose powers are limited by printed rules.[4] The common law trust is more frequent than the corporation in group one, and comes largely out of Boston. In form, group one differs chiefly from group two in the fact that under it the managers—whether trustees or directors—have no separate organization, unless they choose to create one which enters into a contract with the trust or corporation, while under

[2] See, for example, Smith, Investment Trust Funds A and B, pp. 7–10.

[3] For Declaration of Trust of the Bond Investment Trust, see Grayson, pp. 390–397, who also reprints another of this type, pp. 397–404.

[4] It, together with the Boston Personal Property Trust and the Fidelity Investment Association, is described in Chapter III. The Association for Mutual Investment, organized in Massauchusetts in 1926, has several series which require monthly payments for ten years, and pay no dividends until such time, but may be redeemed at any time before on 30 days notice. The Investment Managers Company has a series of separate voluntary revocable trusts, joined together for investment under a single indenture in a single fund.

the plan of group two the management company [5] stands apart immediately from the trust fund it creates. In either case, of course, the honesty and capability of these managers is fundamental. The trustee found under group two parallels the custodian or depositary often used under group one, though of course in a much stronger position.

The investor votes only where he buys common stock in a corporation. Where he purchases registered certificates or shares in a trust, the fact that he can usually revoke the trust at will and withdraw is assumed to be sufficient. The trustees are therefore usually made self perpetuating, and only rarely subject to outside control, as in the Massachusetts Investors Trust, where the depositary's President or Vice President must approve the selection of a new trustee. Sometimes, among the second group of trusts, the participants are given the right to remove the trustee and designate a successor (or to do so in case the trustee resigns),[6] but never to change the management, which is the basic feature that determines success or failure.

Usually no par value is set, or \$100, rarely \$50. Some trusts set a specific minimum participation, notably the Investment Managers Company, which now specifies \$10,000 (formerly \$5,000 and at the outset nothing) in its A Fund and \$1,000 in its B Fund. Some of these trusts show certain variation from type. The Old Colony Trust Associates apparently can even be changed into a full fledged

[5] Both the Investment Managers Company and the Security Management Company are joint stock associations organized under the laws of the State of New York, as is the Mutual Investment Company. The latter's investment policy, too, is similar to the fund type, but its structure involves a conscious and substantial trading on the equity by the management, as was seen in Chapter V.

[6] Legal problems concerning the indenture which arise chiefly with respect to list trusts, are discussed in the following chapter. Extracts from the Indenture of the Investment Managers' B Fund are given in Fowler, pp. 308–332.

British type should the trustees so desire. The State Street Investment Corporation, with 31,054 no par nonvoting class B shares outstanding on December 31, 1927 (61.5% owned by the officers) and 100 no par management class A voting shares (all owned by the officers) apparently represents mere attempt to perpetuate control as in a common law trust.[7] Finally, the Security Management Company's First and Second Investment Funds, add to the fund idea a moderate organizer trading on the equity. Investors buy a unit certificate of one class A and one class B share in the fund, similar to the usual corporate type unit of preferred and common. For each four class B shares thus sold to the public, the management company has the right to buy one class B share. Since the class B share sold nets the Fund $1.00 (exclusive of fiscal agent commission of $1.00), and the Company pays only $1.00 for each, as contrasted with $50 paid for each class A share ($4 and $100 in second fund) the effect is to provide a more liberal managerial compensation than the current annual fee affords.

Since in these trusts the investor is regarded as owning his proportionate share of the securities and / or cash held in the fund, the tax problem is treated differently than in the case of a corporate type trust. There the trust—whether corporation or common law trust—is regarded as an operating entity and pays the Federal corporation income tax of 12% of its net taxable income, deducting therefrom such part as is derived from dividends on the stocks of domestic corporations. A fund trust of the kind described in this chapter pays no such tax, but furnishes the investor in-

[7] Incorporated Investors is a Massachusetts corporation whose stock has been deposited in a voting trust for 15 years, and certificates issued against it to investors. Thus the same object of perpetuating control is achieved.

stead with a statement showing his proportionate share of the amount of income from each source, distinguishing the amount exempt from Federal income tax, exempt at the normal rate, amount of "Capital Gain," and balance subject to taxation.[8]

Some indication of the prevalence of this form of trust is afforded by the following figures, showing par value or issue price of securities outstanding at the close of 1927 or early in 1928.[9]

Class	Date of Organization	Name	Amount
1a.	1893	Boston Personal Property Trust	$ 2,108,600 *
	1907	Alexander Fund	1,818,100
	1923	The Bond Investment Trust	2,034,600
	1926	The Bond Investment Trust of America	217,500
	1924	Massachusetts Investors Trust	3,974,600
	1925	Incorporated Investors **	7,433,008
	1928	Jackson & Curtis Investment Associates	1,340,500
1b.	1927	Inland Investors, Inc.	2,000,000
	1924	State Street Investment Corporation	2,255,444 ***
2.	1925	Investment Managers Company Investment Trust Fund A.	13,530,300
	1927	Investment Managers Company Investment Trust Fund B.	1,943,800
	1927	Security Management Company First Investment Fund	1,027,089
	1927	Security Management Company Second Investment Fund	1,590,546

* Appraisal value of fund Feb. 29, 1928, $5,048,100.
** Classified correctly despite its name.
*** Excludes $965,848 paid in surplus.

8 Tax problems in the case of list trusts present certain peculiar features, which are discussed in the following chapter.

9 These figures are somewhat later than those contained in the Survey of the Attorney General of the State of New York, pp. 28–29.

INVESTMENT POLICY

A considerable proportion of these trusts specialize their holdings. The two Harris Forbes bond trusts have held bonds exclusively, although permitted to make certain investments of a short term nature also, such as notes, bankers acceptances and United States Government obligations. Some others either place special emphasis upon common stocks, or confine themselves exclusively to them, other than for temporary categories.[10] Relatively few favor a broader policy embracing all classes of securities at all times.

In general, investment restrictions are few in number and often entirely absent. The Investment Managers Company sets certain requirements for the stocks it takes—listing on the New York Stock Exchange and monthly transactions therein during the past 12 months, and a minimum capital issue of at least $20,000,000 in its A fund, monthly quotation in the Chronicle or similar publication approved by the board during the preceding year, similar minimum capital stock, or, for a member of the Federal Reserve System, $10,000,000 capital, surplus and undivided profits, in its B fund. In either case, new and inactive issues are excluded, as are corporations with insufficient financial backing. Both the Massachusetts Investors Trust and the Incorporated Investors use the device of an approved list of stocks.[11] This is filed with the depositary and shareholders

[10] Set, for the Investment Managers Co. A Fund, at tax exempt securities, United States Government obligations, and call or time loans against 120% of New York Stock Exchange listed stocks or bonds.

[11] Some time ago the former's list contained 232 stocks, in addition to stocks of banks and trust companies.

are advised of changes therein by the trustees. While thus flexible, it gives some information to participants of the kind of stocks in which their funds can be placed. The Alexander Fund contains the unusual provision that any one dissatisfied with a security purchased may go to a Board of Overseers elected by the shareholders from among themselves and, if they agree with him, can force the manager to sell the security. In general, the stock holdings of the trusts to date are confined to "aristocrats," and include but few lesser known companies,[12] especially if the list be small in size.

The customary investment restriction is the same as found in the British corporate trusts, namely, relative to the percentage of assets that may be placed in one security. This is set at 5, 7 or 10%, at times with certain exceptions. Actually, percentages held are substantially less. The two bond trusts hold, respectively, 105 and 43 bonds, world wide in scope, with 2½% and 3% as the actual maximum in one issue. The Massachusetts Investors Trust holds 139 common stocks, while the Alexander Fund holds 165 American securities, both bonds and stocks, with a maximum of 2% in any one. The Security Management Company holds 38 and 48 respectively in its two funds—between 20 and 30% each in bonds, preferred stock, common stock, and cash and call loans, while Inland Investors, Inc., holds 15% bonds (4 issues), 75% stock (21, including 2 preferred) and 10% call loans. In contradistinction to them stand the Incorporated Investors, with only 31 common stocks and ⅓ of the fund in call loans, and the Investment Managers Company, with 29 and 23 common stocks, respectively, in its two funds and somewhat less than half of

[12] Inland Investors, Inc. specifically limits itself to stocks on which dividends have been paid for three years.

each fund in call loans—permitted now to hold not over 30 common stocks.

Evidently the investment policy is by no means homogeneous. While the Alexander Fund, for example, tries for turnover profits, the Massachusetts Investors Trust and the Incorporated Investors buy for permanent investment. The former selects investments "with sound appreciation the chief object rather than immediate yield. Growing investments produce growing yields." The latter sold only two stocks during 1926 and 1927, both because of less favorable situations which had developed. Both trusts, in fact, seem to espouse the common stock theory emphasized by E. L. Smith, President of the Investment Managers Company, in his work on Common Stocks as Long Term Investments, published in 1925. Mr. Smith confines his attention to a limited number of stocks in the thought that a larger group cannot be supervised effectively. In order, however, to avoid undue concentration of risk, in addition to placing not over 5% of his funds in one corporation, he is not permitted to place over 20% of his funds in one industry, nor to hold over 10% of the stock of any one corporation,[13] thus protecting the disinterested investment view point.

Mr. Smith's company explains the purpose of its trust as follows:

"Investment Trust Fund A has been organized to afford investors the advantage and protection of sound investment management applied to that portion of their resources which they wish to have invested for the greater part of the time mainly in a diversification of common stocks:

1. By providing an investment plan in which a proper

[13] Inland Investors, Inc. specify 25 and 12½% respectively.

relation is established between current income and increase of principal, over a period of years, ignoring temporary market fluctuations.

2. By examining various industries and selecting the most desirable.

3. By appraising the character of management and earning capacity of the leading companies in these industries.

4. By watching for changes both in the condition of the industries as a whole and in the character of management and earning power of individual corporations, and by changing investments to accord with sound analysis of the latest available information relating to these factors.

5. By noting changes in financial conditions which may indicate that the larger part of an investment in common stocks should be placed temporarily in bonds and other maturing obligations, until conditions again favor common stocks."

DISTRIBUTION OF INCOME

Shares usually bear no fixed rate or, where one is named, it is a minimum figure.[14] Some of these trusts proceed on the thought that appreciation in the securities held will provide adequate reserves, hence pay out practically all current income, including turnover profits, to the participants. Thus the Alexander Fund sets a rate of 6% on a new series, and increases it to 7% when the break-up value is 115, 8% when 130, 9% when 140, 10% when 150, etc. Others, instead, provide for building up reserves. The Investment Managers Company in its A fund pays at the rate of 5% per annum on the amount invested (face value

[14] Except for the two Harris Forbes bond trusts which set a flat 5%.

of the certificate), plus 12½% annually of the income earned in excess of 5% payable prior to March 1 that year, thus emphasizing reinvestment of surplus income for both increased protection and profit.[15] The Security Management Company has what is in effect a similar plan, with the added proviso that the distribution shall not reduce the liquidation value of the fund below $50 in its first fund and $100 in its second (the par of its A shares), while it also permits more than 50% of excess income to be distributed only after the liquidation value of the B shares has increased to $15 and $30 respectively. Inland Investors, Inc., requires that at least 1/10 of the net profits be set aside to surplus, until the latter equals 20% of the paid in capital.

A similar result in building up reserves is achieved by certain trusts which do not treat turnover profits as income. The Massachusetts Investors Trust "follows substantially the practice laid down by the Probate Court of Massachusetts for the guidance of trustees appointed under wills in the manner of distinguishing between principal and income. Profits from sale of securities, the sale of rights and stock dividends are treated as additions to capital instead of distributing them to shareholders as dividends. However, where corporations make a regular practice of declaring stock dividends in lieu of cash dividends, such stock dividends are usually sold and the proceeds treated as income. Rights when issued by any of the corporations instead of being sold are used to subscribe for

[15] It can, however, pay dividends out of capital in its discretion. The theory is that of a trust administered for each certificate holder, who may need the income. If it protects the principal against loss in time of adverse market conditions, it may in fact well pay the dividend and yet be better off than if it had retained the securities during a time when they depreciated, meanwhile paying no dividends.

additional shares, thus increasing the assets and income of the trust." Turnover profits it shows as surplus, to which it adds a small amount of current earnings. Incorporated Investors pays dividends solely from cash earnings, never from capital gains. Both these trusts, it should be noted, emphasize a long run common stock investment policy. Incorporated Investors, it may be noted, has on several occasions "capitalized" to a small extent the appreciation in its portfolio, in 1927 through a 5% stock dividend and in 1928 through a 2% one, and on June 1, 1928 doubled the number of the no par shares outstanding.

At the opposite pole from trusts which emphasize current return stands Investment Trust Fund B (The Accumulative Fund) of the Investment Managers Company. This pays no cash distributions at all to certificate holders,[16] but reinvests all income. It is felt that some individuals and organizations require such a policy, for example, the young investor, the business man in the prime of life who wishes to provide against his retirement from active life, the parent who wishes to set aside a fund to safeguard a child's future, and the individual wishing to create an endowment for a special purpose and having insufficent funds immediately available. Investors who, instead, wish current income, can have recourse to the Company's A fund.

THE MANAGEMENT AND ITS COMPENSATION

Investment counsel, some securities dealers and some banks have interested themselves in fund trusts. At times, the trust is run in a security dealer's office, as is the case with the two Harris Forbes bond trusts, the Jackson and

[16] Neither does the Association for Mutual Investment, whose plan is outlined in note 4.

Curtis Investment Associates, or the Incorporated Investors under their contract with Parker, Putnam & Co. Or a concern may be hired to do the work, as is evidently the case with the State Street Investment Corporation and the State Street Research & Management Corporation and with the Old Colony Trust Associates and the Old Colony Corporation. Allied hereto is the plan followed in the funds administered by the Investment Managers Company and the Security Management Company. Again, the work may be divided between a bank (which handles the routine phases) and the trustees (who deal with investment policy), as in the Massachusetts Investors Trust. Finally, the entire facilities of the affiliated bank may be employed, as is evidently the case with the Shawmut Association.

From these facts, it is obvious that no elaborate managerial mechanism is often provided, but use made rather of the facilities afforded by those interested in the trust. Boston trustees obtain the management for a fee; while investment counsel put their smaller clients into the trust, which they advise for a fee. The same is true of securities dealers who have formalized a discretionary account and of Boston banks which have created such trusts. Dealers who newly create such a trust may arrange to sell its shares as well as to provide or to participate in the management.

Compensation varies and is difficult to compare. Generally the amount set includes most of current operating expense, the balance going to the trustees or managers for their work, but in some trusts this is not done. Only one of the more prominent organizations of this type gives the trustees no compensation, namely the Jackson & Curtis Investment Associates. The affiliated security dealers evidently receive their sole remuneration in their exclusive contract to sell shares and in their dealings with the trust. Certain trusts specify a percentage of the value of the fund, namely the State Street, Incorporated Investors and Investment Managers. This is 1% per annum for the first, and one-eighth of 1% quarterly for the other two, the latter equal to the usual investment counsel fee of one-half of 1% per annum, but whether exactly the same expenses are covered in all three cases it is difficult to say. And the complication arises that, while in the first no special compensation occurs from sale of the trust's securities, in the second the associated dealers receive a commission on sales, and in the third the company (which oversees its own distribution) charges both an entrance and an exit fee of 1% each. The effect of a small exit fee is to cover expense, of a larger one, to tie the manager's interest more directly into the trust.

An equal number of trusts compensate management in relation to income, rather than on a "professional" fixed rate basis. The Massachusetts Investment Trust pays the trust company 3% of gross income for its work and the four trustees together another 3%. The trustees of both the Harris Forbes bond trusts are entitled to receive up to 5% of gross income (and 1% of the amount finally distributed), but to date have actually received nothing. The same rate is fixed in the Boston Personal Property Trust. Inland Investors, Inc. pays its executive committee 5% of net profits. The Alexander Fund gives the manager 10 cents of net income for every 90 cents paid participants, in addition to paying certain expenses, while the Old Colony Corporation receives 6% of net income plus expenses and disbursements incurred in connection with the work.

The National Shawmut Bank is to serve the Shawmut Association in "supervisory and other capacities," although it is forbidden by law to hold stock in the latter. The bank is to receive one-eighth the annual net earnings, plus an amount equal to one-half any dividends paid to shareholders above $2.50 per share on original issue prices of $50, $51.50, and $52.50 per share. In addition, when the trust terminates, it is to receive one-third the assets after the common shares have been paid the price originally paid and 5% per annum thereon, less dividends paid. The Security Management Company has a composite method of payment. It receives semi-annually one-fourth of 1% of the net value of the fund at the close of each six months.[17] In addition, for every four units of 1 A and 1 B share, sold originally to net the trust $51, ($100 and $4 in the second fund) the Company has the right to buy 1 B share, which participates with the other B shares in dividends and ultimately in distribution of principal. Its affiliated fiscal agent receives a commission of $1.00 per unit upon entrance of a new participant, and the Company itself receives 50 cents per A share in its second fund upon exit.

Indirect compensation is also possible through dealings with the trust. Some trusts therefore forbid any such profits to interested parties. The Investment Managers Company covenants that it will not deal with itself, its officers or directors as principals in making purchases or sales of securities for account of its investment funds, but any director, member or officer may accept customary brokerage commissions on purchases and sales for its funds. The Security Management Company has a similar provision in its indenture, and the Massachusetts Investors Trust likewise guards against the practice. But other trusts specifically permit such dealings, for example, the Old Colony Trust Associates.

[17] Made cumulative, and not to be paid if result is to reduce value of A shares below $50 or $100 per share, according to the fund in question.

RAISING CAPITAL

These trusts generally have their participations on tap, selling continuously. The investor can enter at any time, paying a price based on the then break-up value of the fund. Where the stock has a par value, this results, of course, in paid-in surplus. They raise their capital quite cheaply. The trust sponsors provided a back log of funds at the outset, and also aid later when the natural momentum of a going concern begins to be felt in attracting funds. Thus the Investment Managers Company has on its directorate members of the securities houses of Roosevelt & Son and Wood, Low & Company, as well as of Scudder, Stevens and Clark, investment counsel. Again, the National Shawmut Bank—which made but a single offering instead of a continuous issue—offered rights to its stockholders to subscribe to the stock of the Shawmut Association, in the ratio of two in the trust to one in the bank. In addition to these 300,000 shares, to be placed at $50 each, the bank management subscribed for 100,000 at $51.50 each and the remaining 80,000 were to be offered to customers and friends of the bank at $52.50 each. Similarly, the Old Colony Corporation bought for cash at $50 each 10% of the 400,000 shares of the Old Colony Trust Associates, and offered 150,000 shares to stockholders of the Old Colony Trust Company.

In some cases, the affiliated security dealer has a contract to dispose of shares at a limited commission. The Massachusetts Investors Trust fixes the price charged by its fiscal agent at break-up value plus a reasonable selling commission that it sets, while Incorporated Investors is not permitted to pay over $6.00 a share commission. The Survey of the Attorney General of the State of New York placed the cost of raising capital to the former at 6¾%, to the latter at 5%.[18] Both, however, try to approach the public in rather an extensive fashion. In contrast to them, are other trusts which evidently rely upon the close contacts of dealers with their customers to keep the costs of capital down. The Jackson and Curtis commission is limited in the indenture to a maximum of 2%, while Maynard, Oakley & Lawrence, fiscal agents for the Security Management Company, received $1.00 of the initial unit price of $52 on the first fund, and $1.00 of $105 on the second fund.

When the trust itself acts as distributing medium, either no commission is required, as in the State Street Investment Corporation and the Boston Personal Property Trust, or else a small entrance fee is charged, as in the Investment Managers two funds. That Company, it was already noted, receives 1% of the face value of certificates issued, which the investor pays in addition to the face value.

An over the counter market is found in the minority of cases. Examples are afforded by the Massachusetts Investors Trust, Incorporated Investors, Jackson and Curtis Investment Associates, and the Shawmut Association. Instead, the certificate itself is made non-transferable and the market is usually provided solely by the trust itself, which gives the investor the right to revoke the trust and obtain the cash value of his participation[19] or, what amounts to the same thing, sell it back to the trust. Usually this is at any time, although for the Jackson and Curtis trust only quarterly. Some danger to the trust seems to inhere in such a provision, in forcing liquidation by the trust at an inopportune time. The Investment Managers

18 P. 63.

19 The Bond Investment Trust does not. The four trusts named above have a two fold market. In some cases, as in the Investment Managers Company trusts, the management can redeem the holding of any individual at its discretion.

Company and the Security Management Company seem to avoid this by permitting the Company, at its option, to tender the investor the proportionate part of each investment held, with adjustment of proportional parts—a procedure which might prove awkward in actual practice. The latter Company further undertakes in its first fund (not in its second) to redeem the Company's B shares in the same proportion as the public's are redeemed, if for a thirty day period it has more than the percentage set outstanding. The State Street Investment Corporation instead announces that the officers of its affiliated management company intend to maintain a reasonably close market on its shares at the figure set, in case the trust itself cannot buy shares offered to it.

In order to fix the issue and the redemption price, periodical appraisal is usually required, for example, every day, week, two weeks or, more often, every month, in order to afford a basis. From that figure is usually added or deducted a stated fee. The latter ranges from 50 cents per unit for the Security Management Company's second fund, 1% for the Investment Managers Company, $2 for the Massachusetts Investors Trust and the State Street Investment Corporation to 2% for the Jackson and Curtis Investment Associates, and liquidation cost for the Incorporated Investors.

SOME ACTUAL OPERATIONS

Publicity is the order of the day for most of these trusts. They publish regular balance sheets and income accounts. To them are added lists of securities held, in some cases with cost as well as current market shown. Shareholders are kept advised of charges in some trusts, and records of operation are made available to them. Regular audits are provided.

Hence a study of the results of operation of several of the older trusts of this type may be made, though handicapped by the fact that average size of fund during the year is not available.

The following table presents the 1927 figures for several trusts:

<table>
<tr><th></th><th>Massachusetts Investors Trust</th><th>Incor-porated Investors</th><th>Boston Personal Property Trust</th><th>State Street Investment Corp.</th><th>Investment Managers Co: Fund A.</th><th>Security Management Company Fund 1 ||</th><th>Fund 2 §</th></tr>
<tr><td>Interest and dividends</td><td>$246,918</td><td>$92,437</td><td>$220,981</td><td>$75,436</td><td>$549,770</td><td>$49,147</td><td>$30,094</td></tr>
<tr><td>Turnover profits</td><td>[21,744]</td><td></td><td></td><td>375,653</td><td>928,370</td><td>45,190 ¶</td><td>43,862 ¶</td></tr>
<tr><td>Total income</td><td>246,918</td><td>92,437</td><td>220,981</td><td>451,089</td><td>1,478,140</td><td>94,337</td><td>73,956</td></tr>
<tr><td>Expenses and taxes</td><td>31,608 *</td><td>33,010 **</td><td>20,420</td><td>97,380 ‡</td><td>66,855</td><td>4,799</td><td>4,256</td></tr>
<tr><td>Net income</td><td>215,309</td><td>96,626 ***</td><td>200,561</td><td>353,709</td><td>1,411,284</td><td>89,538</td><td>69,700</td></tr>
<tr><td>Dividends</td><td>204,270</td><td>99,555</td><td>168,588</td><td>92,571</td><td>746,938</td><td>44,252</td><td>32,923</td></tr>
<tr><td>Surplus for year</td><td>9,493</td><td>..... †</td><td>31,973</td><td>261,138</td><td>646,346</td><td>45,285</td><td>36,777</td></tr>
</table>

* Of which $7,051 was paid to the trustees.
** Of which $15,570 was management fee.
*** Balance of $59,427 plus $37,199 "other credits."
† Undivided earnings to date $246; part of dividend paid from undivided earnings on hand at opening of year.
‡ Includes $17,399 salaries.
|| Period February 15th–December 31st.
§ Period July 1st–December 31st.
¶ Net.

This table illustrates vividly the differences in policy already noted. The first three trusts do not regard turnover profits as current income available for dividends. But, among them, the first two pay out current income as dividends, while the third "ploughs back" a substantial portion. The other three trusts place considerable emphasis on turnover, though in varying degrees. And they have had the policy of building up substantial reserves, in addition to unrealized capital gains on securities held.

Rather more complete figures are available for the Investment Managers Fund A, covering a three year period, showing income, etc., as a rate percent on the average face value of certificates outstanding:

	1925 *	1926	1927
Interest and dividends	5.76%	5.27%	4.75%
Profits from sales of securities	3.89	4.51	8.01
Total income	9.65	9.78	12.76
Management compensation	.65	.57	.58
Distributions on certificates	5.49	5.57	5.84
Balance of income paid to redeeming certificate holders	.05	.02	.76
Undistributed income	3.46	3.62	5.58

* Jan. 10 to Dec. 31.

Taken in conjunction with this table should be data showing the amount and composition of assets, as follows:

	1925	1926	1927
Total assets at market value Dec. 31st	$4,646,005	$9,815,341	$15,394,561
Percentage in call loans, receivables and cash	63.2%	70.2%	47.3%
Percentage in common stocks	36.8%	29.8 *	52.7

* On June 14, 1926, 49.3%. It is explained that the Jan. 1 percentages are likely to be lower than at other periods during the year, due to seasonal changes in stock prices.

The most significant feature in this Company's operations is the extent to which it has placed emphasis upon turnover profits. Commencing operations in a time evidently believed inauspicious for thorough-going application of its common stock theory, it seemed to hesitate in the earlier years, placing large amounts in call loans and trading enough in the common stocks to realize adequate total returns to investors—in other words, treating common stocks as short term investments. Perhaps its experience goes to show that investment cannot be made to follow mechanical rule, and that in any common stock as long term investment theory many shifting currents exist, of which a competent management may take additional advantage in the process of further riding the general tide. It explains the "straddling" between call loans and stocks on each date as part of a conscious policy of insurance against risk of misjudgment of the market. In making direct comparison of earnings of trusts of this type with those of corporate trusts, it should be borne in mind that the former do not borrow. A basis for comparison might be afforded by assuming borrowing by an individual investor at his bank in order to carry these participations, to the degree that a corporate trust issues senior securities.

SELECTED REFERENCES

Grayson, pp. 240–258.
Robinson, pp. 300–310, 314–318.
Smith, E. L. Investment Trust Funds A and B. Investment Managers Co., 1927, p. 83.
—, Why We Organized an Investment Trust (extracts from address before District of Columbia Bankers Association, reprinted from United States Investor, Aug. 25, 1928), p. 14.

CHAPTER IX

FIXED OR STOCK CONVERSION TRUSTS
(Bankers' Shares)

At the opposite pole from a trust vesting complete discretion in the management stands one which seeks by careful initial formulation of the set-up to dispense entirely with managerial judgment. Such is the object of the fixed trust, which has often been termed the "American" as distinct from both the corporate "British" type and the fund type described in the preceding chapter, whose investment policy more or less follows British ideals and ideas. The fixed or rigid trust is also known as the bankers' share or stock conversion type. It raises its funds by issuing certificates or beneficiary shares generally evidencing pro rata participating ownership in specified securities deposited with a bank or trust company that acts as trustee.[1] Thus its problem or work is two fold; first, to set up the plan of the trust and create units mechanically thereunder; and second, to sell the certificates. The investor relies upon the known selection of securities initially made.

EARLIER AMERICAN BANKERS' SHARES

The simplest trusts of this type merely deposit the stock of one company with a trustee and against it issue participations, which they term bankers' shares. These are

[1] In structure it is thus similar, in some ways, to the second type of fund participation discussed in the preceding chapter.

similar to the well known voting trust certificates, but have a different purpose. The idea has not been extensively used; in the United States the Cities Service and the Ford Motor of Canada cases alone come to mind.

In 1919 the Cities Service Company, a well known holding company for public utilities and oils, deposited 30,000 shares of its common stock with a trust company and the latter issued 300,000 nonvoting bankers' shares against these. Ten bankers' shares were exchangeable for one common share. Thus the shares were made available to a wider circle of investors by reducing the size of the unit without changing the par value.

The same idea of "splitting" the shares and increasing public interest by thus making a high priced stock available to investors of limited means was evident in the Ford Motor of Canada case. But the latter operation was carried on as a straight security selling proposition by a concern which had no connection whatsoever with the Ford Motor Company of Canada, Ltd., whose stock was deposited, and, moreover, as carried on in some quarters, was tinged with fraud. The Investors Share and Unit Corporation of New York purchased capital stock of the Ford Motor Company of Canada, Ltd. and deposited the same with a trust company as trustee under a trust agreement. The trustee in turn issued negotiable certificates for bankers' shares, each representing a one one-hundredth part of a share of Ford stock. Holders of bankers' shares received all dividends declared on the Ford stock and had the privilege of converting an aggregate of 100 bankers' shares into one share of the underlying stock.

A word as to the legitimacy of such operations: It may be argued that the issuing company is the best judge as to market price of its issues and the extent of the circle of its stockholders. From the investor's point of view, however, as distinct from the company's, the plan seems perfectly legitimate, provided always that no effort be made to interest investors of very small means and that the cost be not excessive. In the Ford case, the project met with disfavor because of the illegitimate use of the Ford name in sales efforts and because of the size of the "spread" between market price of the underlying stock on the Curb and the sale price of the bankers' shares to the public. In 1925 the former varied from 491 to 524, and the latter, from 650 for some houses to 750 for others. This is obviously an excessive price to pay for the relatively small service rendered in making the participations available. The state courts stopped the sale in April, 1925, while in November, 1927, an individual who attempted to revive the plan was prosecuted for misusing the mails in furtherance of a scheme to defraud.

THE STOCK CONVERSION AND INVESTMENT TRUST, LTD. OF LONDON [2]

The British have applied the idea in a more thoroughgoing fashion and added some refinements. The Stock Conversion and Investment Trust of London had as its primary object the acquisition of such "heavy" railway common stock as Union Pacific, Canadian Pacific and Great Western. Against these holdings, for which it acted as trustee, it issued preferred and common stock, say £1,000 in 4% first preferred, perhaps also £500 in 5% second preferred, and £1,000 in common against £1,000 in railway stock yielding 7%. From time to time it has searched out opportunities for such operations. Some of the people associated with this trust organized the London, Midland and

[2] Its conversion operations are alone treated here. For detailed study of its other activities, see Grayson, Chapter X.

Scottish Trust in 1924. This organization proposed to issue £97 10s of 4% preference, £50 of 5% preferred and £100 of deferred stock for each £100 of the road's ordinary stock and asked holders of the road's shares to turn them over to it on such terms. The railroad itself strongly opposed the use of its name by the trust, and issued a circular recommending that its shareholders reject the conversion offer.

In its policy of replacing the deposited security by several issues of different investment positions, this trust seems similar to the corporate type discussed in earlier chapters. The underlying theory in such operations is twofold. First, it is sought to separate the assured from the extraordinary and uncertain income and to represent each by a different security. Second, it is believed that the combined market price of the three splits will exceed that of the unsplit original and deposited stock. Under adverse conditions, the part as to whose dividend doubt arises, alone may decline in value, while the prior part retains its old value. The difficulty lies in the fact that this has not proven to be the case in time of serious financial or political crisis. Then the split stocks became worth appreciably less than the original railway stocks. Thus the expected gain from holding split stocks in preference to undivided disappears just at the time when the necessity of realizing may become urgent. Furthermore, the income of the holder of the split stock is reduced by the amount necessary to cover the expense of the conversion operation. As in the situation where the market value of the shares is merely split, which was discussed in the preceding section, the question arises here as to how far outside aid is necessary from the investor's point of view to revise or readjust the issuing company's notions as to its own capital structure.

A further counterpart of the fixed trust has existed for many years in Holland. The Administratie Kantoors, which correspond roughly to our trust companies, first issued their trust certificates against shares of individual companies, such as American railroads. The shares were issued in their name, and bearer certificates (alone listed on the Amsterdam Stock Exchange) issued against them. Later, they issued trust certificates against groups of holdings—similar to American fixed trusts, but generally confined to a single field and designed to appeal to large investors.

FIXED TRUST STRUCTURE

The fixed trust found today in the United States differs from both the earlier American type and the British type just described, in that the collateral deposited with the trustee[3] includes securities of a number of companies. It thus aims "at affording security by 'converting,' for example, a certain 'unit' composed of purchased common stocks in several companies into a far greater number of share claims, each equally participating in dividends accruing to all the deposited securities."[4] Against each identical block or unit composed of the specified list of pre-selected securities, is issued a specified number of shares, generally 1,000, usually of no par value or, in the case of two leading trusts, of $10 par in order to reduce taxes. These shares represent equal participations in the deposited securities, and are sold to the public. The trust is the fund composed of the identical units of collateral deposited with the trustee, created under the indenture or declaration of trust between the company creating it and the trustee, and the investor

[3] The word "trustee" as used in this section is to be understood to include a bank or trust company acting as depositary as well as trustee. See the next section.
[4] Robinson, p. 269.

buys no interest in the company that deposits the securities.[5]

Under these circumstances, the investor usually has but little interest in the corporation creating the trust. It is generally chartered in New York and has but a limited capitalization, supplied by a small group of people. This capital is designed merely to provide an initial expense fund, to tide over the period until sales of shares in volume begin, and then to provide, as far as necessary, a revolving fund with which to acquire securities to put in trust. As soon as the securities are deposited, the shares can be issued and delivered to purchasers. The revolving fund need merely be a margin against a brokerage account or against a collateral loan from the trustee bank, especially if sales are made on a when issued basis. The corporation is usually the creature of a banking house, which in general is one of the smaller houses. Its directors, practically never mentioned because management is not required in this class of trust, are nominees of the banking house, and often to all intents and purposes the corporation and the banking house are identical. The corporation is permitted to assign its rights under the indenture.

The trustee is the bank or trust company which is a party to the indenture. Under some indentures the depositor corporation may remove the trustee, while under all the trustee may resign, in either case upon specified notice. In some cases the existing shareholders have a voice in the selection of the successor trustee, for example, a majority must ap-

[5] A curious combination of the American idea of using securities of several companies, described in succeeding sections, with the British plan of issuing several securities against the collateral, was found in the Investment Trust Participating Bonds and Units, Series A, issued by the Durant Corporation of New York in 1924 against common stocks of ten companies. The units had an accumulative income feature and were convertible into the bonds. The plan was never very popular.

prove, but in others the depositor alone makes the selection. In certain trusts, too, the substituted trustee must conform to certain requirements as to size and location.

The security sold the investor is variously called a bankers' share, a trust or trustee share, or a trust or investment trust certificate. It is issued less frequently by the corporation than by the bank, but usually by one and countersigned by the other. Of late, both usually sign on the face. One thousand shares are usually issued against a block of securities, the list being adjusted so as to price the certificate attractively. The original issue prices range from about $10 to $20, with specialized trusts up to $30. Nonvoting certificates are generally sold in bearer form with dividend coupons and talons attached, in denominations of from five to one thousand shares, and for two trusts, five thousand shares also. While sales vary greatly in size, it would appear open to serious doubt whether issue of five share certificates is desirable, especially if the share is priced around $10 or $15. The man who cannot buy a larger amount would seem a fit subject for the savings bank instead. In some cases sales are made on an instalment plan. This is both costly and open to all the objections usually made to instalment purchase of common stocks, instead of waiting until funds are in hand for outright purchase.

The trust emphasizes long run gain, hence early termination is not desired. Some run for 99 years (unless later than 20 years after the death of the last of a named group), some for 20 years with the proviso that the owners of 75% of the outstanding certificates may extend and some have no fixed date. Generally the depositor may terminate if less than a certain number of shares, such as 100,000, are outstanding. One permits the trust company to terminate in that case, as well as if the depositor ceases business or is unable to act and has not assigned its rights to a successor.

THE TRUST INDENTURE

In a legal sense, the relation created by the indenture between the depositor, the trustee who holds the *res* and the *cestuis* is a peculiar sort of trust. As has been pointed out by one writer, "the function of safeguarding principal becomes secondary, while the function of 'clearing house of equities' stands out at the main purpose of the trust." Perhaps better stated, "the purpose is to subdivide equities of a large invested fund in order to safeguard the principals or equities of small investors." [6]

The effort is made to create a trusteeship "shorn of the responsibility of management of the trust property by the terms of the trust indenture." If the trust company simply held the fund physically as a deposit or bailment it would perform an agency service; but since it is made nominee with title to the funds and securities vested in it, the service exercised is a trust.[7] Thus one indenture carefully provides that the right to redeem the certificate and receive the distributive share is assignable, not the share itself, in order to meet the New York law. But several "indentures," namely, those creating Diversified Trustee Shares and Investors Trustee Shares, are purposely drawn instead on the theory of a deposit agreement rather than the creation of a trust in personal property. The "trustee" becomes a custodian or depositary and the ownership of the deposited

[6] Smith, J. G. The Development of Trust Companies in the United States, New York, 1928, p. 115. The indenture for Diversified Trustee Shares, Series B is given in Fowler, pp. 333–361.

[7] Franklin, G. S., Investment Trusts. A paper read at a meeting of the New York State Bar Association January 21, 1928, p. 7, regards the investor as settlor of the trust as well as *cestui*.

stocks, despite their holding by the "trustee," is vested in the holders of the shares, in order to avoid possible conflict with the New York rule against perpetuities in personal property, as well as for tax reasons.[8] The attorneys liken the certificates for shares to subscription or interim receipts, while they claim exemption for them from blue sky laws in states which exempt stock listed on the New York Stock Exchange.

These brief statements will make clear that the present legal status of such trusts is unsettled, at least in the sense that no court decisions exist. It is undecided as to what duties and liabilities the court will hold the trust company, whether in the office of trustee or of depositary for the certificate holders. Strict legal theory and de facto relationship by no means agree. The only prominent case in which an indenture of the trust type has been called in question was in the so-called New England case, in the spring of 1928. This involved a managed list trust, of the type described in the next chapter. It had sold full paid certificates against named securities deposited with a trustee and also part paid certificates against which the customer paid one-third down. The latter certificates it claimed to be carrying against loans at various banks, but, in point of fact, had "gone short" and never purchased the securities nor had the certificates issued. It was urged by partial payment investors that full paid investors be not permitted to convert their certificates into underlying securities, but that the trust fund be held intact for administration by the receiver for the depositor on behalf of both classes of holders. This plea was made on the twofold theory that the trust was not a legal trust, and that the sums provided by the partial payment holders had been used to acquire securities placed in the trust property and

[8] Generally the fact that the *cestui* has full power of revocation is regarded as sufficient, even though not limited on lives.

could be traced into that property. The United States district court in Massachusetts, however, held in a dictum (Liberty National Bank, etc. vs. New England Investors Shares, April 4, 1928) that the securities deposited under the trust agreement constituted trust property, to be held for the benefit of the lawful holders of the shares representing a beneficial interest therein. Had the other contention been upheld, it would of course have sounded the death knell of this form of trust.

In view of these legal uncertainties, J. G. Smith favors a trust in which the trust company, acting as trustee, becomes the active manager.[9] The only trust in which it approximates this position is in the issue of Investment Trust Shares, Series A. Here the indenture between the Prudential Company of Chicago, as depositor, and the Chicago Trust Company, as trustee, provides for issue of certificates by the latter without countersignature by the depositor and has the trustee take all further steps in the administration of the trust, including maintenance of a market for the certificates.

THE INVESTMENT LIST

The fixed trust relies upon growth in a carefully selected list of securities for its appreciative appeal. The list is usually a general one, comprising both rails, utilities and industrials; but in some trusts it is specialized, covering an industry believed to possess peculiar appreciative possibilities, such as public utilities, oils, or Canadian bank stocks.

Inasmuch as the initial list is rigid, the securities contained therein must be selected with special care. A small list of well regarded stocks is chosen, due attention being given, for example, in constructing a general list, to in-

9 P. 118.

dustrial and geographical diversification, as achieved largely through the subsidiaries of the companies selected. Considerations such as the following enter:

Basic character and national scope of the industry, with good future prospects,

Demonstrated earning capacity and soundness of management,

National prominence and representativeness in field covered,

Satisfactory dividend returns over a period of years, as well as substantial increase in surplus,

Listed and actively traded in on national exchanges,

High rating by securities services.

In this way, a cross section of American industry is obtained, the number of shares of each company included being varied so as to distribute the investment over the entire list in accordance with the judgment of the creator. A concrete illustration is afforded by the following figures for certain leading trusts:

Date Formed	Original Offering Price		Shares	Companies
Dec. 1924	10¼	Trust Certificates, Series A, Nation-Wide Securities Co. (Calvin Bullock) **	300 *	25
Apr. 1925	14½	Diversified Trustee Shares, American Trustee Share Corp. (Throckmorton)	141 *	24
Dec. 1927	18⅝	Diversified Trustee Shares, Series B, American Trustee Share Corp. (Throckmorton)	128	24
May 1927		Investors Trustee Shares, Series A, Investors Trustee		

* Originally.

** Unit is 2500 shares, for all others 1,000. Contains 2 shares of 2 companies' preferred stocks.

Date Formed	Original Offering Price		Shares	Companies
		Foundation of the United States, Inc. (Jordan, Colyer & McGuire)	122	55
April 1927	17⅜	Fixed Trust Shares, American Basic Business Shares Corp. (Lisman)	130	30
Oct. 1928	7½	Basic Industry Shares, American Basic Business Shares Corp. (Lisman) ***	132	30
April 1927		Investment Trust Shares, Chicago Trust Co.	130	26
Sept. 1927		Provident Trustee Shares, Provident Trustee Share Foundation, Inc.	150	40

*** Unit is 2,500 shares.

The fairly narrow extent of diversification is evident, likewise the faith reposed in a single class of security. Other trusts exist in which the number is even less, as was the case in the early Bonner Brooks trusts and the original Industrial Trustee Shares of Throckmorton, mentioned in Chapter III, as well as with a Denver trust formed several years ago and liquidated at a profit in the thought that the five securities included afforded insufficient diversification. A number of local dealer trusts exist patterned on the larger trusts.

A variant is found in United States Electric Light & Power Shares, Inc., Trust Certificates, Series A, offered May, 1927, at 29¼. This is a second Calvin Bullock trust, which has had extremely rapid growth. It embraces 343 shares of 69 companies, of which 134 shares of 45 companies represent preferred stock, in considerable measure of local operating companies. These are added to 209 common shares of 24 companies, which form the bulk of the trust, and of the common shares 90 are those of a single holding company —the North American Company. Evidently the purpose is to add to the common stock, which is to furnish the enhancement as the industry progresses, a back log of current return on the relatively high yield preferred stocks in view of the 6% at which the certificates aim.

Substitution in the various trusts may be made only under very narrow specified conditions. The more rigid only change the securities in the case of recapitalization or split up of shares, or exchange of stock by reason of merger, consolidation, reorganization or sale of property of any of the companies, when the new security created is substituted for the old one held. The two Calvin Bullock trusts differ in that they also permit sale should safety become impaired, but limit reinvestment to securities already on the list,[10] selected by the depositor. Two Canadian bank stock trusts —Canadian Bankstocks, Inc. Trust Certificates, and the Canadian Bank Stock Trust Shares, Series D, of the United States Shares Corporation permit reinvestment only in one of the banks named (10 in the former and 9 in the latter) and limit the amount in any one to 25% of the total investment.

Inasmuch as the unit is the center of attention, these trusts generally publish no balance sheets, and do not show size unless, as in the case of United States Electric Light and Power Shares, Inc., or the Lisman trust, they are especially proud of their record. In general, however, they are required to notify certificate holders of any changes in the list, and the same information would be available, of course, in the circulars and other sales literature as soon as made.

[10] The utility trust also permits investment in similar securities of the same company when a security is retired through call or exchange of stock.

UNDERLYING INVESTMENT THEORY

The investment theory underlying the fixed trust has provided the principal center around which controversy as to its merits has raged. The general query as to the value of any investment trust device—whether the results from the creation of the intermediary are worth the cost it entails—arises with particular force in the case of this type of trust. Could not the investor, it is said, package the securities himself, and fare just as well without undergoing the expense involved? The answer usually made lies in the direction of original selection of securities, convenience and avoidance of certain tax features, together with advantage from special protective devices such as a reserve fund, which some trusts introduce, as well as the very protection which the rigidity of the trust gives against unintelligent tinkering by the holder himself with his securities.

Waiving this question we come to the next query—what are the relative merits of the fixed trust as compared with other types? Advocates of the fixed or static trust decry speculation; instead, they proclaim investment. They do not deny that lucky speculation by managers of a blind pool may yield much greater returns, especially when aided by a strong bull market; but, they claim, so also may it yield much greater losses. They emphasize investment for the long pull, disregarding intermediate security price fluctuations and feel that greater profits will be made by permanently maintaining a position in the securities of basic industries than by seeking to trade in and out and catch short term speculative price movements. They appeal largely to the common stock theory of investment so popular in recent years. The diversified group of common stocks is to secure income high relative to the stability and the security obtained. More than that, it is to show appreciation as the country grows and the individual companies reflect that increasing prosperity. Buy "Shares in America," asks one trust. And, by growing with these common stocks, it is to protect purchasing power and eliminate the gamble in the cost of living.

This seductive appeal it reënforces by locking the carefully selected package of securities in the trustee's vaults, quoting John Moody's view:

> "The best type of investment trust, without any question, is that where specific collateral is deposited with a trust company back of the Trust Certificates or other securities issued and sold to the investor. When this specific collateral, which cannot be changed without liquidating the trust, is placed behind the certificates which are issued, there can be no question as to the character of the security."

Thus it seeks to minimize errors of commission. Lack of a widely known class of disinterested investment trust managers in the United States is overcome by reducing the factor of management to its smallest proportions. For management the investor relies upon the boards of directors of the companies comprising the investment list. True, he has to rely on the honesty and intelligence of the sponsors for the initial selection of securities, but he can see what he gets, and buys no "cat in a bag." The investor knows at all times just what he has, and knows that that group consists of common stocks of leading American concerns. He eliminates risks of inefficient management, guilty of errors of judgment, danger of speculation and possibility of manipulation. Only in such a trust, it is claimed, will he get the full benefit of appreciation in value.

Now turn to the other side of the picture. To select a security certain to endure, much less to grow, for 99 years in succession is impossible. The early Throckmorton trust, now liquidating, Industrial Trustee Shares, in fact included the ill fated American Woolen common in its list of twelve companies. But the chances of a security going wrong are slight, say fixed trust advocates. The leaders of today are likely to continue to be the leaders of tomorrow and to adapt themselves to changing industrial conditions. The decay of their principal industry finds them entrenched in other lines. Granted even that a security or two may go wrong, their shortcomings will be outweighed by the action of the other stocks. The protection obtained far outweighs the possibility that gains achieved may not be the maximum possible. And it is even claimed that the investor would lose more through misjudgment if he tried to time his purchases and sales of underlying securities. So, too, would he lose if he tried to wait and buy the trust shares at the lowest price, for he cannot judge accurately and it is therefore better to pay the slightly higher figure of the moment if prices were to decline. The Calvin Bullock trusts try to give the management a chance to get out of danger spots promptly; but the other trusts set their face against all such tinkering. Finally, if dissatisfied, the investor can, as will be seen in a later section dealing with marketability, revoke the trust if he desires; but this requires watchfulness on his part, which the trust tells him he does not need.

The siren song of some fixed trust advocates is that their trust has been scientifically and objectively devised, so as to reduce the human element—and therefore presumably fallibility—to a minimum.[11] Scientific tests of securities and industries determine the list of securities. The maximum decline in past dividends determines the size of a reserve fund provided in one trust. Wherever possible, such objective tests are employed and mechanical, automatic trust

11 See, for example, the Lisman trust's literature.

operation is provided. In certain instances, of course, this cannot be. No one can tell the investor when shares are at a low point, and it is far better for him to disregard such minor price movements as occur. But these situations are reduced to a minimum and half a loaf is better than none. In other words, the art of investment disappears entirely and no attention is paid to the work of investment specialists. The maximum of investment intelligence is presumed to be that of the man on the street.

The Attorney General of the State of New York, in his Survey [12] felt that the effect of issuing shares in rigid trusts might generally be to stimulate stock prices unduly. Attention is concentrated upon a small list of securities. These are acquired from time to time; due to the method of sale, there is a steady investment demand, but no supply for purposes of profit taking, as in the case of ordinary investors.[13] Were these trusts large enough to absorb a substantial part of the floating supply of the stocks in which they are interested, this would be a real disadvantage. Fortunately, as yet, they are not. Undoubtedly, in such a case, manipulation would be possible and the trust could be "held up" for exorbitant prices, which investors in their shares might mistakenly regard as evidence of underlying prosperity of the company and hence be eager to continue purchasing shares. Fortunately, too, such trusts can hardly be organized to unload a security upon the public, and the securities selected are such as possess broad and relatively stable markets. They merely divert "potential investment capacity" from "speculation to investment," but cannot increase this "potential investment capacity."

12 Pp. 46–48; Supplemental Survey, pp. 13–17.

13 In this like customer and employer ownership, which are probably of greater size than the trusts are.

INCOME AND ITS DISTRIBUTION

Fixed trusts generally distribute dividends semi-annually, although the two Calvin Bulloek trusts, for example, fix a quarterly period. Sinee accrued dividends from date of previous dividend are usually added to the priee the purehaser pays for his shares, the holder on the dividend rate reeeives a full dividend, as is the ease with bonds. But in the Nation-Wide trust, an investor who buys after the opening of the quarter merely gets interest at the rate of 6% for the time his funds are invested, instead of the full dividend. Some trusts distribute the entire sum available among the shareholders, and have the trustee either paid direetly by the depositor (whieh presumably reimburses itself in the initial ''spread'') or else indireetly from the interest on the dividends on underlying stoeks in its hands between date of eolleetion and date of distribution. Other trusts, however, make a regular deduetion for the trustee's serviees. They also permit deduetion, if neeessary, for taxes or other governmental eharges, or legal expenses sueh as those ineurred in defending the indenture.

The distributable ineome arises from eash dividends, both regular and extra, and, in general, also proeeeds of sale of rights and stoek dividends. Several exeeptions, however, exist as to treatment of stoek dividends. The Throekmorton B and Colyer & MeGuire trusts merely sell fraetional or odd shares reeeived, (the former also any stoek dividend other than eommon stoek), while the Calvin Bulloek utility trust sells stoek dividends of under 10% and fraetional shares. These trusts seek to build up prineipal, and thereby meet in part the objeetion sometimes made to treating rights and stoek dividends as current ineome, and thus distributing what is at least partly eapital. Lacking cash with which to subscribe when rights are issued and not wishing to reduce distributable income too greatly, the rights must be sold, while fractional shares are an awkward constituent of identical units. At the same time, the fixed trust leaves the accumulation of a surplus for the investor's protection to the underlying companies, whose earnings are presumably substantially in excess of the dividends they pay. Unlike other classes of trust, it does not turn over its portfolio but in effect builds up a hidden reserve of unrealized capital gains to protect its shareholders.

The Attorney General of the State of New York has insisted strongly upon accumulation of a reserve by fixed as well as other trusts.[14] He feels that a reserve would serve two purposes. First, it would protect against the fact that the exact liability of fund, managers and trustee is as yet unsettled. Second, it would be useful for dividend equalization purposes. The latter, in fact, is the chief purpose in actual practice. Three trusts now have such funds. The Lisman trust and the Chicago Trust Company Trust, Series A (it also offers Series B without reserve) require deposit of an initial reserve fund of $1,000 with the trustee, in addition to the specified securities. If the amount available for dividends exceeds 50 cents per share semi-annually (which is at the rate of 6% per annum on the original offering price of 17⅜ of the Lisman shares), the excess is added to the reserve fund until the latter equals $1.50 per share. Conversely, if the amount available is less than 50 cents, the deficiency is advanced from the reserve fund, and is repaid from future amounts which exceed 50 cents. This amount is very low and was easily exceeded in the first year. The two actual dividends from July 1, 1927 to July 1, 1928 were 53 cents and 71 cents (36 cents from cash dividends, 35 cents from sales of stock dividends and rights). The

[14] Survey, pp. 90–92; Supplemental Survey, pp. 22–23.

amount is said to have been scientifically determined from dividend fluctuations over a number of years, yet only provides a yield of 6% on the initial price, and is a gesture there. The Calvin Bullock utility trust instead accumulates its reserve fund from earnings entirely. If the amount available for dividends is greater than a 6% dividend rate requires, one half the excess shall be placed in a cash reserve fund, until the latter equals 6% of the market value per unit. The fund may be drawn on for any deficiency in amount available below 6%. On December 31, 1927 it amounted to $4,791, as compared with $8,749,581 of certificates outstanding and three months later to $28,387, as compared with $17,546,639 of certificates. The new Lisman trust instead has a sum equal to one year's dividends paid in at the outset, to which no addition is made.

Such a dividend equalization reserve would seem of but limited use, and where a dollar figure is set might be very small after a considerable time has elapsed. Opponents of any dividend reserve further criticize it on the theoretical ground that in stabilizing dollar amounts of dividends it causes fluctuations in amounts of dividends in terms of purchasing power. Yet the situation which called it forth is apparent from the following dividend figures per share for two trusts:

	Nation-Wide (Quarterly)	Diversified (Semi-Annual)
April, 1925	$.206	
July	.194	$.3295
October	.205	
January, 1926	.236	.7381
April	.231	
July	.205	.5631
October	.203	
January, 1927	.202	.4997

	Nationwide (Quarterly)	Diversified (Semi-Annual)
April	.313	
July	.255	.7953
October	.272	
January, 1928	.217	.5023
April	.256	
July	.258	1.016

The Lisman trust also proposes to use the reserve for paying assessments in reorganization, which the Calvin Bullock industrial trust asks the trustee to pay and reimburse itself from future payments to shareholders. The Throckmorton trusts state frankly that their shares are non-assessable and that if any of the stocks were assessed, it would be in bad shape and would have to "go overboard."

METHOD OF SELLING TRUST CERTIFICATES

Either the depositor, or the security house with which it is affiliated, undertakes to sell the trust shares. Both have had to create a special sales mechanism. This they do largely by wholesaling to (selling through) a group of dealers who receive a specified commission for selling, either with or without commitment on their part. The fixed trusts have been alert to "educate" the public (dealers, dealers' salesmen and investors) by means of advertising and literature to an understanding of the relatively new device and have stressed modern merchandising methods, instead of the traditional ones used in the financial field.[15] Their sales are made continuously, the security being "on tap" as needed. There is no limit to the size of the trust, and it is built up, unit by unit, as sales are made. Incidentally, if the depositor operates several trusts, the holders of the one pro-

[15] See, for example, Fowler, J. F. Jr., Merchandising Problems of the Investment Trust, Printers Ink, April 26, 1928.

vide an excellent list of prospects to whom to offer the other. The method of selling has the advantages of requiring only a small capital investment by the trust's organizers, and of having the security available at all times as demand for it appears. It is a relatively easy way to get a trust started.

But the method has a twofold disadvantage. Its utility from a sales point of view is limited, as is its utility from the point of view of investment policy. It is only fair to state that fixed trusts claim advantages of their sales methods over those of single issues. The dealer without a commitment has no pressure placed on him to sell, and therefore is tempted to turn to greener pastures, either because a time limit exists on some other issue or because it yields a larger return, feeling that he can always come back to the trust shares. Again, some trusts have unwisely had local dealers "load up" their customers as a result of sales campaigns, and have then shifted as sales fell off to some other dealer, who would repeat the process. Such shares do not "stay put"; the very fact of continuous sale invites a flow back of trust shares from purchasers as they are traded out. Of course, the dealer's commission is charged back if they return too soon, for example, within 60 days.

Far more serious, however, is the investment drawback. Security purchases are made continuously, regardless of the level of the security markets. Fixed trust advocates claim, of course, that their interest is only in the long pull and that they are not interested in intermediate fluctuations. The time for the investor to buy is when he has money to invest. Granted that this may be true, the purchaser of trust shares may find himself in the position of buying at the peak, and being forced to carry a temporarily depreciated share. Especially is this true as his own and the salesman's imagination is likely to be fired by the long continued "bull market" which existed. Again, no pressure is placed upon the depositor to buy advantageously for the trust. It buys as it sells and is merely a passive manufacturer of shares to order as customers buy. In such cases, it either shifts the duty of judging entirely to the public or else urges the public to disregard levels entirely. If it instead anticipates orders it buys for its own benefit instead of trust benefit, since it adjusts the price of the shares daily. In short, the method of purchasing permits no exercise of judgment, but is utterly inflexible. It protects the depositor, but it undoubtedly handicaps the buyer.

THE QUESTION OF "SPREAD"

The service which the depositing corporation and the trustee render is fourfold: creation of shares, selling of shares, routine administration of trust and making a market for shares outstanding. The American Basic Business Shares Corporation of F. J. Lisman & Company elaborates them at greater length as follows:

1. Setting up the trust,
2. Buying the underlying stocks,
3. Transferring and delivering stocks and deposited cash to trustee,
4. Cost of preparing engraved certificates,
5. Issuing certificates,
6. Telegraphic expense,
7. Cost of shipping shares to dealers,
8. Exchange and interest,
9. Syndication expenses and profit,
10. Profit to dealers,
11. Advertising expenses,
12. Office expenses,
13. The expense of selling underlying securities,
14. The cost of tax stamps.

The usual method of direct compensation for these varied services is by an initial definite loading or "spread" between the cost of the underlying securities and the sale price of the shares to the public, which lumps them all together. The Attorney General of the State of New York gives it at "generally somewhere between 10% and 20%." This is true of some of the smaller trusts, several of the better known showing a lesser figure. Three computations follow:[16]

	American Basic Business Shares Corp. (Oct. 5, 1927)	American Trustee Share Corp. (Nov. 4, 1927)	Am. Trustee Share Corp. Diversified B (May 8, 1928)
Aggregate market quotations of stock underlying each unit	$15,967.85 *	$19,079.89 ***	$18,180.00
Cash on Deposit with trustee:			
Reserve fund	1,000.00		
Accumulated earnings on stocks	438.53	431.74	166.50
Odd lot and commission	60.53	66.61	59.80
	17,466.91	19,578.24	18,406.30
Allowance for profit, expense of issue and distribution	1,000.00 **	Add 8½% (divide by 91½%) ****	add 8½%
	18,466.91	21,396.93	20,116.17
Sale price of share	$18½	$21–3/8	$20–1/8

* Market cost.
** Now 6 per cent. The new trust specifies no spread figure.
*** Last closing price.
**** Includes trustee compensation, while the other trust covers it annually from interest on accumulated earnings on stocks.

16 The Chicago Trust Company trust A (with reserve) has a spread of $1 per share, trust B (without reserve) $1.10 per share. To name a set figure, such as $1, at the outset is a mistake. It may be only 4% if price rises to 25.

The American Trustee Share Corporation, whose original spread was 10 per cent, states that its figure is theoretical, since purchasers of the shares are protected at the price next day. Its net profit in the best periods has averaged less than 2% gross, without allowance for office and administrative expense.

The two trusts cited, as well as those of the Chicago Trust Company, specifically state the "spread" in their sales literature. Others do not, although, of course, it may be roughly computed. In no case is it restricted by the indenture. This lack of publicity has often been criticized severely. Yet no disclosure is made in the usual corporate financing, whether for investment trust or other issue, as to the cost of such financing, and in the corporate investment trust promotion the compensation of the organizers is often by no means easy to discover. The only special reason for asking the fixed trust to disclose it, is the fact that such trusts are often offered to the small man, who presumably requires special protection against fraud and undue exploitation. Yet the anomalous situation arises that, were the limited spread featured, the average uninitiated investor would be appalled at the size of the "spread." He would not compare it with costs of raising capital for other projects, but would look solely at the fact that only 92 cents or so of every dollar he paid was actually invested for his benefit.

In addition to "spread," extra compensation may be obtained for some trusts by the depositor through its relation with the trust. In particular, if the depositor buys securities and later puts them into the trust after they have risen, he may profit from good judgment. The American Trustee Share Corporation and the American Basic Business Shares Corporation state that they sell entirely on a "when issued" basis, and only purchase the underlying securities for a unit when that unit has been sold, hence avoid such problems. Again, when a stock exchange house runs the trust, it can execute trust orders and receive regular compensation, but this opens no possibility of abuse. Where the trustee's compensation is included in the initial spread, the depositor may retain it, and merely use the interest thereon to pay the fee annually, as occurred in one managed list trust. It seems far better to keep the initial spread to a minimum; to state the trustee's compensation specifically in the indenture, and to pay it currently out of income available for dividends, including in the income all interest on funds in the trustee's hands.

Finally, the "spread" is paid at the outset, and thus the interest of depositor and investor is not linked together. True, the major expense is a sales expense and is usually so covered for all security issues. But the only subsequent interest of the depositor lies in the future ability to sell more of the shares or other securities to investors. If confidence be had in the entirely automatic character of the trust, perhaps this is no drawback; but if the many problems sketched here have force, the link would seem to be rather weak and unsatisfactory. Only the Chicago Trust Company trusts specifically avoid this feature by relegating the depositor to a minor place, and bringing the trustee forward.

MARKETABILITY AND CONVERTIBILITY OF TRUST CERTIFICATES

Unlike the corporate trust, but like the fund type, the market price of the certificates depends upon the market price of the underlying securities, and varies directly with them, perhaps each day.[17] There is no doubt that the sec-

[17] This is true where the depositor manufactures the shares to order as desired by investors. The Nation-Wide shares show much greater stability.

ondary over the counter market with banks and dealers for the certificates is much narrower than the market for the underlying stocks. It is maintained by the house sponsoring the issue. Thus both the Lisman and Throckmorton trusts fix a spread of 75 cents per share between bid and offering prices, leaving, on the dates cited in the preceding section, 28 cents, $1.05 and 95 cents respectively as net loss to the investor who immediately resold his shares. The Chicago Trust Company as trustee is required by the indenture to buy back any shares of its trusts offered at the market price of the underlying collateral as defined in the indenture, in which case the investor loses the entire spread. Of course, where the issuing house makes the market, it will do so largely because of its influence upon future sales, and may well reach a point at which it is buying back more shares than it is selling. How long it would be willing to do so and maintain a bid price above the break-up value, which means a net loss on repurchased shares which it cannot resell, is of course another question.

The indentures also permit the holder of a specified number of shares at his option to convert his shares into the underlying securities, plus his proportion of the reserve fund, if any, and accrued dividends. Generally a unit can be converted. But in the Colyer and McGuire and the Throckmorton B trusts half a unit of 500 shares may be converted, since they carry an even number of shares of each company in their investment list. Thus also the Chicago Trust Company permits redemption of one-fifth of a unit, the holder getting one instead of five shares of each stock. The Lisman Trust permits the holder of a unit of 1,000 shares to convert and the holder of less than a unit to receive either the portion of the deposited property applicable to his shares or the market value of such deposited property, at the option of the trust. In actual practice, it is said, he will receive either cash or full shares plus cash in settlement of fractional shares.[18] The holder who converts and receives the underlying collateral can of course sell the same in the market and thus is established a minimum value for the shares. The holder of a smaller number of shares receives an indirect rather than a direct benefit, through the fact that dealers will purchase somewhat below the break-up value and convert units as accumulated.

The Attorney General of the State of New York believed that, partly owing to lack of accumulation of reserves, market prices of fixed trust certificates were comparatively unstable as compared with market prices of securities issued by management investment trusts.[19] Of course, the fixed list prices reflect stock market vicissitudes; but the vicissitudes of an average of high grade issues. And they have no element of hope which sent prices of corporate trusts, unanchored to asset values, but capitalized to represent roseate estimates of future earning power, sky rocketing, and then caused them to drop as that hope faded in the disillusionment of a falling stock market at the middle of 1928. Happily, some figures for asked prices are now available for trusts in existence a number of years.

	Nation-Wide	Diversified Trustee Shares	Dow Jones Monthly Average (20 industrials)
1924			
December	10–1/4—11		110.4
1925			
January	11–1/4		125.3
February	11–1/4		120.5
March	11–1/4		123.9
April	11–1/4	14–1/2	118.1
May	11–1/4	14–1/2—15–1/4	121.1

18 For cash, the new trust provides a penalty of 50 cents per share.

19 Survey, pp. 22–23; Supplemental Survey, p. 13. He follows Robinson, p. 281. See also pp. 68–69.

	Nation-Wide	Diversified Trustee Shares	Dow Jones Monthly Average (20 industrials)
June	11-1/4—11-1/2	14-3/4—15-1/8	129.7
July	11-1/2	14-7/8—15-1/2	131.8
August	11-1/2—11-3/4	15-1/8—15-5/8	134.5
September	11-3/4—12	15-1/4—16-3/8	139.8
October	12 —12-1/2	15-3/4—16-3/4	144.8
November	12-1/2—12-3/4	16-3/4—17-1/8	157.9
December	12-3/4	16-3/4—17-3/8	152.1
1926			
January	12-3/4	16-1/2—17	158.5
February	12-3/4	16-1/2—16-7/8	156.8
March	12	15-3/4—16-3/4	151.0
April	11-1/2—12	16-1/2—16-3/8	140.4
May	11-1/2	16 —16-3/8	143.4
June	11-1/2—12	16-1/4—16-3/4	142.3
July	12	16-1/2—16-7/8	153.0
August	12-1/4	16-7/8—17-3/8	161.8
September	12-1/4—12-1/2	17-1/8—17-3/4	163.9
October	12-1/2	17 —17-3/4	159.7
November	12-1/2	17-3/8—17-3/4	150.5
December	12-1/2—12-3/4	17-1/2—17-7/8	157.3
1927			
January	12-3/4	17-1/2—17-7/8	155.2
February	12-3/4	17-5/8—18-1/4	156.3
March	12-3/4—13	18-1/4—19	161.4
April	13	18-7/8—19-1/2	160.7
May	13	19-1/8—20-1/4	164.6
June	13-1/4—13-1/2	18-7/8—20-3/8	171.2
July	13-1/2	19 —20-3/8	168.1
August	13-1/2	20 —21-1/8	184.2
September	13-1/2—15	21-1/4—22	191.6
October	14-1/2—14-3/4	20-3/4—22-3/8	198.4
November	14-1/2	21 —22-3/8	181.7
December	14-3/4—15	21-3/8—22-1/2	196.6
1928			
January	14-1/4—16	20-3/4—21-3/8	203.4
February	13-3/4—14-3/4	20-1/4—20-3/4	198.0
March	13-3/4—14-1/2	20-3/8—21-5/8	194.8
April	14-1/2	21-1/2—22-1/4	209.3
May	14-1/2—15	19-3/8—20-1/4	213.5
June	14 —15	18-1/2—20	220.3

These figures are useful for a preliminary estimate of fixed trusts. They show a substantial growth in the bull market (over 50% in three years), and yet reveal the greater stability of the trust issues. Taken in conjunction with the dividend figures for the trusts given earlier in the chapter, they reveal an excellent yield on the initial prices, but one steadily declining as time went on. Taking these two sets of figures together they reveal at once the strength and the weakness of the fixed trust—its ability to grow in assets and in earnings, especially in a bull market; but they reveal also its inability to protect itself against adverse market conditions. This type has yet to face a bear market, hence its test, both from investment conditions and investors' attitude, still remains for the future.

From a collateral loan point of view, the fixed trust is by far the easiest for the banker to evaluate. A survey by the Bureau of Business Research of New York University, made in 1927 among the larger banks, indicated that 202 or 54.2% of all the 373 banks replying preferred the fixed type as collateral as against 112 or 30.0% that preferred the trading type. Of these 202, 180, or 89.1% believed the collateral value to be increased by the conversion privilege, while 177, or 65.1% out of 272, believed this right of conversion necessary to supplement the maintained market for trust shares.

THE TAXATION PROBLEM [20]

Last, the fixed trust is often said to have certain advantages from a tax point of view, in addition to its convenience for the investor. The holder of shares in both Throckmorton trusts, it is said, manages to "eliminate 188 dribbling dividend checks a year, transfer requirements of

[20] See Denham, E. A., Risks Ignored by Investment Trusts and Investment Trusts and Trust Companies, Barron's Financial Weekly, August 22, 1927 and September 19, 1927 respectively; also Wallstein, L. M., Some Legal Questions in Relation to Investment Trusts. The Corporation Trust Co., New York, pp. 30.

48 companies, 48 notifications of change of address, 48 or more proxies a year."

More important, however, is the minimization of taxes claimed. This relates both to inheritance and to income taxes. Dividends representing cash dividends from deposited stocks are exempt from the normal Federal income tax. Proceeds from sale of stock dividends, rights, etc., are, however, subject to tax. Some trusts require the trustee to furnish statements of the source of dividends on payment of coupons, while others merely require it to do so on application. The American Trustee Share Corporation explains:

"Our attorneys advise us:

'It would seem as a practical matter that the Government would not raise any objection, in the event of the certificate holder claiming that the entire amount received as dividends on his certificates, which would include distribution from the sale of stock dividends, rights, etc., is exempt from the normal Federal income tax.'

Shareholders, on application, will receive a statement showing the amount of income derived from cash dividends and the amount derived from sale of rights and stock dividends. That portion of Diversified Shares dividends which represents cash dividends of underlying companies, is clearly exempt from the normal Federal income tax. Proceeds from the sale of stock dividends and rights are exempt only when there is no profit over the average cost of stock, based on the number of shares held plus the number of shares received or subscribed for. Hence that portion of Diversified Shares dividends which represent profit from sale of rights and stock dividends, if any, might theoretically come under the normal tax.

In practice, however, income thus coming under the normal tax would be exceedingly difficult of determination and would be relatively little in amount. When all income from Diversified Shares is declared as dividends, the aggregate of income taxable by the Government is actually somewhat increased.

Although the law does not specifically cover the situation, there is no question as to the proper procedure to be followed. Income on Diversified Shares should be declared as dividends received from stock, exempt from the normal income tax.''

Equally important inheritance tax advantages are claimed by some trusts, although others are silent. Excessive cost, annoyance and delay in settling is avoided, likewise necessity of preparing and filing waivers and other papers. This arises from the fact that the estate is said to be subject only to the Federal inheritance tax and inheritance tax in the state in which the decedent resided. Multiple state inheritance taxes, placed upon estates of individual nonresident holders of securities of corporations incorporated in that state, are avoided.[21] The American Trustee Share Corporation states:

''For all practical purposes, Diversified Trustee Shares and Diversified Trustee Shares, Series B, are exempt from duplicating State inheritance taxation.

On highly abstract legal grounds, the States might claim inheritance taxes on such portion of the investment in

21 Wallstein, pp. 26, 28, 29, states that the New York State Tax Department, in a communication to the State Law Department, went on record as holding that the transfer of a certificate for trust shares in the state of a nonresident decedent is not subject to the New York State Transfer Tax; nor, he believes, are certificates liable to transfer taxes in states other than New York, in which are organized corporations whose stock is included in the underlying unit.

Diversified Shares as is represented by corporations under their jurisdiction. There is, however, no conceivable way in which such taxes could be imposed or collected, since Diversified Shares are in bearer form, and are not under the jurisdiction of the several States except the State of legal residence of the decedent. When the Shares change hands there is no record of this transaction on the books of any transfer agent or corporation."

One can readily see the significance of the bearer as distinct from the registered form of certificate in connection with taxation. It is only fair to state that there is not entire agreement among attorneys, as is suggested in the last quotation. Practical difficulty of tax collection, to buttress legal exemption, makes the selling argument advanced by many trusts. Moreover, the theory of exemption proceeds also on the theory that the trust creates no body or organization distinct from the individual certificate holders. If it be held analogous to a corporation, the Federal corporation tax of 12% of net income would apply.[22] Again, it is at least an open question whether income not distributed in its entirety to holders of certificates (which would then ordinarily be taxable to their respective beneficiaries and subject to Federal income tax exemptions, deductions and rates as the law allows them as individuals) within the year in which received by the trustee, is not returnable by and taxable to the trustee, and at a far higher rate than would be taxable by most of the individual holders. Thus the trustee of a trust faces certain tax uncertainties, at least, and while it is authorized to pay any taxes or governmental charges out of trust income, this hardly gives the investor any clear understanding of his position.

[22] The trusts themselves (where the trust form is used) are not, it is generally held (in the absence of court decision) subject to Federal taxes as associations, since the trustee conducts no business and is not subject to control by the beneficiaries.

SELECTED REFERENCES

Fowler, Ch. V. Contractual Trusts, pp. 68–80; Ch. VI. Contractual Trusts—Continued, pp. 81–92; Ch. VII. General and Specializing Trusts, pp. 93–109; Ch. XIV. Problems of Taxation, pp. 179–193.

Grayson, Ch. X, Analysis of an Unusual Investment Trust Over a Thirty-Seven Year Period, pp. 119–130.

Robinson, Ch. XIV, Stock Conversion Companies, pp. 264–281.

Williams, pp. 23–26; 88; Ch. IX, Fixed, Limited and Specialized Trusts, pp. 70–75.

Attorney General of the State of New York, Survey, pp. 45–56, 62–64, Supplemental Survey, pp. 12–25.

Fowler, J. F., Jr., The Case for the Contractual Trust. United States Investor, April 28, 1928, pp. 930 ff.

Lee, H. F. Why the Fixed Investment Trust? United States Investor, April 28, 1928, pp. 928 ff.

Rukeyser, M. S. What Investors Should Know About Investment Trusts, Forbes, Dec. 1, 1927.

Wallstein, L. M., Some Legal Questions In Relation to Investment Trusts, The Corporation Trust Co., N. Y., 1928, pp. 30.

American Basic Business Shares Corporation, A Fixed Investment in America's Prosperity, 1927, pp. 28.

American Trustee Share Corporation, Diversified Data 1927, pp. 39; Supplement to Diversified Data, 1928 Edition, pp. 6; Diversified Data, Diversified Trustee Shares, Series B, 1928 Edition, pp. 31; Shares in America, pp. 20.

CHAPTER X

MANAGED LIST TRUSTS

In structure as in parentage, the managed list trust represents an offshoot of the fixed type. It was created by people familiar with the fixed trust, yet distrustful of the rigidity which the latter entailed. Hence they modified it in the interest of flexibility, seeking all the while to continue the idea that investment discretion should be closely restricted and confined within narrowly specified limits. Otherwise they took over bodily the general plan and methods of the fixed trust. Of these managed list trusts, the New England Investment Trust, Inc., created in 1925, in fact represented the parent stock from which others sprang. It supplied both the ideas and the people for their conduct. As time went on, objections began to be raised to certain features that it and its followers contained. To meet the sales resistance thus engendered, if not to improve its soundness as it became better understood, some trusts introduced certain modifications of the earlier form, both in fundamentals and in secondary tho important features. Pushed to its furthest extreme, the result was a type midway between the fixed trust and the fund trust, instead of one that adhered more or less slavishly to fixed trust standards and practices. Much more ingenuity, it may be observed, can be exercised in drawing up a managed list plan than in devising a fixed trust and, it may be added, this ingenuity has been freely exercised. These devices are conceived in last analysis to make the trust more attractive in the public's eyes and hence to aid sales. The present chapter seeks to point out fully the features in which fixed trust methods have been modified or abandoned, while passing briefly over points of similarity with the fixed trust.[1]

GENERAL STRUCTURE

Like the fixed trust, the managed list trust possesses the elements of depositor and trustee, joined together in a trust by means of an indenture. The depositor corporation is generally independent, rather than the subsidiary of a securities house, although one or more smaller securities dealers or stock exchange houses may be interested in it. This means that the corporation, like the fixed trust and its sponsors, has had to create its own special sales mechanism, instead of confining its attention to trust operation and management. Since it is to manage the list of securities, it must show a competent board of directors.[2] To this, some later trusts have added an advisory committee and/or one or two securities services, such as Moody's and Brookmire's. In some cases, the trust has a specially designed sales subsidiary, as for example, the New England trust and the Investment Trust of New York, Inc.; or due to certain special features, in one case two companies have been created, the Insuranshares Corporation and the Insuranshares Management Co., the former the trust, the latter creator, depositor and manager. Only one trust to date has created a family of trusts, namely, the United States Shares Corp., the others confining themselves to a single field.

[1] The chapter omits discussion of municipal trust certificates, wherein special assessment or other obligations are deposited with a trustee, and certificates issued against them.

[2] For example, Insuranshares Corporation has emphasized the coöperation of Goodwin-Beach & Co. of Hartford, well known insurance stock specialists, who are also represented on its board.

The general problems with respect to the trustee (other than that of compensation, discussed below) are the same as in the case of a fixed trust. The security sold the investor is known by various names, such as collateral trust certificates, collateral trustee shares, trust shares, investment trust shares, or, in the case of one particularly successful trust, Insuranshares. The original issue prices range in general from $9¼ to $12½ on general list trusts, from $20 to $22¼ on bank and insurance stock trusts, and between $33 and $40 for bond trusts. The shares are either no par or have a $10 par ($20 for Insuranshares). The earlier trusts had fully registered shares, but almost all the recent ones have bearer shares as well. Denominations are from five to five hundred shares, although one bank and one general trust stop at one hundred, one general trust goes from ten to one thousand and Insuranshares sets no upper limit. The shares like those in fixed trusts carry no vote, a fact which has often been criticized, but one recent trust (the Investment Trust of New York, Inc.) permits the holder of a unit to get proxies for the underlying stocks if he desires. The tax problems are the same as in the case of the fixed trust, with the added complication that some of the trusts have income from interest as well as from turnover. This is not exempt from normal Federal income tax, and the effort is made to offset such income as far as possible against expense of operation. The claims as to exemption from state inheritance taxes other than in state of residence vary considerably.

Due to the lesser certainty, the maturity is generally shorter than in a fixed trust. Twenty years is a favorite, with ten, twenty-five and thirty years much less frequent. Many of the indentures have come to permit such certificate holders of one unit or more as desire to extend the trust for two additional periods of not exceeding three or five years each. This is held desirable in order to avoid liquidation in depressed markets. In the Insuranshares trust, the managers may extend for twenty-five years additional. The corporation is generally permitted to liquidate the trust when less than a specified number of shares, say 10,000, are outstanding, but in two trusts no such number is set, it being required instead that such termination shall be submitted to a ballot of shareholders and may be vetoed in one by holders of more than one-third the outstanding shares and in another by one-fourth.

Inasmuch as the list is subject to corporation management, the trustee minimizes its responsibility. It tends to certify merely the initial stake or list held, and in respect to substitutions merely carries out the directions of the corporation. Neither is responsible except for bad faith. Hence the trust indenture, feels the Attorney General of the State of New York,[3] loses much of the strength it possesses in the case of a fixed trust, and possesses limitations not always realized by the investor. In other words, automatic or mechanical protection cannot be achieved in this class of trust.

THE INITIAL INVESTMENT LIST

In this form of trust, an investment list is named at the outset, representing the securities comprising the original units. The list is either general, containing rails and utilities as well as industrials, or specialized, covering either banks, insurance companies or bonds. No utility or oil trusts of this type have as yet been formed.

The general type of list is in almost all cases much larger than the usual fixed trust list, although the general group involves the same basic idea of giving a cross section of

[3] Survey, pp. 50–55.

American industry. It includes from 75 to 100 companies, in general one share only of each, in order to keep the value of the unit and thus the price per share, low. The list represents a combination of household names with less known concerns believed to possess peculiar opportunities for development and enhanced value. In general, emphasis is placed upon substantial companies which show earnings much in excess of dividends paid and hence considerable growth in surplus. But the early New England trust consciously included—evidently to bring up the current yield—some preferred stocks and a number of common stocks of companies where the dividend was by no means certain—a hazardous procedure unless one is close to the company, as is shown by the fact that this trust carried a number of its stocks, such as American La France and Phillips Petroleum, into a passage of the dividend.

A concrete illustration of the lists of the general trusts is afforded by the following figures for certain leading trusts:

Date Offered	Original Offering Price		Shares	Companies
Sept. 1, 1925	9¼	Collateral Trust Certificates of New England Investment Trust, Inc. (Since Nov. 1927 New England Investors Shares, Inc.)	130	80 *
Apr. 16, 1927		Collateral Trustee Shares of New England Investors Shares, Inc.	132	80
May 5, 1927	12½	Common Stock Trust Shares, Series A. of United States Shares Corp.	116	100 **
Jan. 19, 1928	12	Common Stock Trust Shares, Series A-1 of United States Shares Corp.	100	100

* Includes 6 shares of 6 preferred stocks.
** Includes 9 " " 8 " " .

Date Offered	Original Offering Prices		Shares	Institutions
June 1, 1927		Investment Trust Shares, of Investment Shares Corporation	262	25
Nov. 1, 1927	13	Investment Trust Shares of Investment Corp. of North America	98	98
Jan. 31, 1928		Collateral Trustee Shares of Investment Trust of New York, Inc.	81	75

Even more popular than the general list trusts have been the bank and insurance stock trusts. Public interest in these securities has grown by leaps and bounds in the last year, as their strongly upward secular trend has been emphasized. At the same time, their high price and unavailable market, prevented the average investor from buying them. The United States Shares Corporation's bank stock trusts are said to be much the largest of their three classes, while the published figures for Insuranshares are as follows:

Series	A-27	$600,000	par value
	C-27	650,000	" "
	F-27	1,800,000	" "
	H-27	5,200,000	" "
	B-28	3,000,000	" "

Data as to the list of these trusts follow:

Date Offered	Original Offering Prices		Shares	Institutions
May 9, 1927	22	Bank Stock Trust Shares, Series C-1 and C-2, U. S. Shares Corp.	30	30 [1]
Mar. 13, 1928	20–5/8	Bank Stock Trust Shares, Series C-3, U. S. Shares Corp.	20	20 [2]

Date Offered	Original Offering Price		Shares	Companies
Oct. 6, 1927		Bank Stock Trust Shares, Series A, of Participating Investors Shares Corp.	30	30 [3]
Apr. 30, 1927	20	Insuranshares Trust Certificates, Series A-27, of Insuranshares Corp.	.	27
May 1, 1927	20	Insuranshares Trust Certificates, Series C-27		28
July 1, 1927	$22\frac{1}{4}$	Insuranshares Trust Certificates, Series F-27		44 [4]
Sept. 1, 1927	$22\frac{1}{4}$	Insuranshares Trust Certificates, Series H-27		52 [5]
Feb. 1928	22–1/8	Insuranshares Trust Certificates, Series B-28		—

[1] Includes 5 banks outside New York City.
[2] Confined to New York City.
[3] Five in New York; rest out of town or Canadian. Has 200 certificates issued against it.
[4] Includes three banks.
[5] Includes five banks.

Insuranshares has a minimum of twenty companies in mind, and the number of shares in each company ranges from about one to 3,075.

The Insuranshares series do not really use the unit device at all in the sense that the others do. Each series constitutes a separate unit. A batch of stocks is deposited and the certificates issued against them are sold. Additional purchases of these and other stocks are made, care being taken merely that not over 10% of the total series fund is held in one company's stock, and additional certificates of the same series are sold. As the price rises, sales resistance increases, and finally the series is closed either by the Corporation or else automatically within one year from date of deposit. A new series under a new indenture with a separate fund is then begun. This procedure probably arises in part from the narrowness of the insurance stock market, hence need of greater flexibility in purchases, and the method of compensation to the management described later.

On the other hand, bond share trusts have made little appeal. They lack the appeal of great appreciation, and the investor who desires a good yield plus bond safety has never seized upon them eagerly. Data for two issues follow:

Date Offered	Original Offering Price		$1,000 Pieces	Issues
June 24, 1925	33	Foreign Government Bond Trust Certificates of Financial Investing Co. of N. Y. Ltd.	15	15 *
May 9, 1927	44	Bond Trust Shares, Series B of United States Shares Corp.	40	40

* This unit has 500, not 1000 certificates issued against it. This trust was liquidating and had only $16,500 remaining out in the summer of 1927 of the originally authorized amount of $4,000,000.

CONDITIONS OF INVESTMENT SUBSTITUTION

Power of substitution was early advocated in order to be prepared for any changes in the situation of the underlying securities, so as to avoid the disadvantages of a fixed trust. But at the same time effort was made to restrict this power greatly, both to define when it could be exercised and what kind of security could be substituted. In other words, the managing company was permitted to exercise discretion only within narrowly restricted limits, and must keep the investors advised periodically of changes in the portfolio.

Recapitalization or split-up of shares, or exchange of stock by reason of merger, consolidation, reorganization or sale of property of any of the companies present no special problems beyond those faced in the fixed trust, and are treated in similar fashion. But added thereto is a situation in which a security actually is or threatens to become impaired in value. Substitution is therefore permitted:

1. If a company liquidates, voluntarily or otherwise
2. If a receiver is appointed for a substantial portion of its property and the receivership continues for sixty days without institution of court precedings for the receiver's discharge
3. If the company fails for one year to pay any dividend on the stock
4. If at any time the depositor receives information that in its opinion warrants the conclusion that cash dividends on the stock will cease either temporarily or permanently to be paid or that the stock will become substantially impaired in value (Presumably an able and well informed management could get out of a stock before its weakening position became generally known and its market price declined, whether through decline in earnings, change in the industry or other cause.)

Conversely, profit taking is permitted, except in the revised New England indenture, sale of a security being allowed when the market value exceeds the average cost of acquisition of the stock.[4] The thought is to take profits when the price rises above intrinsic worth through pool manipulation, struggle of conflicting factions for control, or kindred influences. The United States Shares bond trust adds thereto permission to sell when conversion or other valuable rights of limited duration exist. The Financial Investing Company's earlier bond trust permitted the management to sell to avoid depreciation of principal or to take capital gains, and, upon approval of certificate owners given at a meeting held within specified days after each sale, to reinvest the proceeds in additional bonds.

[4] The original New England indenture specified 25%, the New York 20%, but others do not set any figure.

Insuranshares grants the widest discretion, substitution being permitted if the management shall determine it for the best interests of the shareholders.

But the management is protected by making substitution under the conditions named merely its right, not an obligation resting upon it. Practically, therefore, the management in almost every case receives discretion of the widest sort. It can replace a security when its judgment dictates and the ultimate composition of the fund might readily be entirely different from the initial one. In practice, however, these trusts emphasize long run growth, and therefore minimize turnover.[5] In contrast to these trusts, the revised New England indenture alone represented a reversion to the bankers share type; no substitution can be made to take profits, and substitution ceases when the stock of twenty of the eighty companies is sold or the par value of stocks sold aggregates 20% of the total aggregate par of the eighty deposited stocks.

SUBSTITUTED SECURITIES

It is in defining the securities that may be substituted, that the management is actually restricted. Money is to be made from stock investment, and in almost all trusts the cash proceeds of the turnover must be placed in stocks as soon as possible. In other words, the basic idea is the

[5] Wallstein says "They are not organized to trade in securities, but solely to hold them, obtaining current income from dividends, solely or primarily and not principally or largely from market profits on trading, an underlying objective being to obtain at the termination of the trust the capital appreciation incident to the growth and development of sound enterprises. Market profits, when taken, are only incidental to the main purpose of sustaining or improving the investment quality of the underlying portfolio." P. 3. Arndt says: "The wisdom exercised by the managers at the outset is of the greatest importance; the care and management of the trust thereafter is so circumscribed and safeguarded as to be almost self-operative." P. 154.

same as in the fixed trust, and no allowance is made for an unfavorable general market situation wherein stock prices decline, but reliance is placed instead upon careful selection of individual securities that will hold their own to greater or lesser degree against, if not actually advance in face of, the general market. As in the fixed trust, a bear market is regarded as a temporary manifestation which will be overcome in the long run, and the trust "plays around" solely with stocks.

The substituted stock must be a dividend payer, in the earlier trusts for five consecutive years, in the later ones merely within the six months prior to acquisition, and in the latest United States Shares bank trust, one year. It must be listed, generally on the New York, Boston or Chicago stock exchanges, rarely only on the New York exchange. The United States Shares Corporation adds certain Moody ratings to ensure quality in its general list trusts:

No stock may be rated lower than B

Not more than 10% may be rated lower than Ba

“ “ “ 50% “ “ “ “ “ Baa

“ less “ 20% “ “ “ A or higher

For its bond trust, the corresponding requirements are:

Not more than 15% may be rated lower than Baa

“ “ “ 55% “ “ “ “ “ A

Not less than 75% may consist of issues of which not less than $1,000,000 is outstanding in the hands of the public. For its bank stock trusts, size and earnings are the criterion, as follows:

	C 1–2	C–3
Capital	$2,500,000	$1,000,000
Surplus	At least 50% of capital.	
Deposits	$25,000,000	$20,000,000

	C 1–2	C–3
Reported earnings of last fiscal year	At least 10% over dividends.	

Insuranshares Corporation permits substitution in insurance companies named in the indenture or licensed and qualified to do business in five states or in Canada, and banks and trust companies named in the indenture or having a paid-in capital of $500,000 and surplus and undivided profits of 75% to 100% of capital.

To ensure diversification, not more than 3% or 5% of the market value of the trust may be invested in one stock, nor more than 12% in one industry, except in the case of railroads and public utilities, for which the figure is 20%. What "one industry" means, however, remains undefined. The bond trusts fix 5% for one issue and 10% for one company, and 35% for either foreign, industrial, public utility or railroad bonds. The bank stock trusts fix a maximum of 10% for one institution, except in the case of a company whose surplus and undivided profits exceed five times the capital.

In certain trusts, the trust must submit to the trustee a statement of all proposed substitutions, together with the reasons therefor. The shareholders must be kept advised of changes. Some trusts require this semi-annually, when dividend checks go out, others at least quarterly; the revised New England indenture required shareholders to be advised when the substitution was proposed.

From the sketch of attempted restrictions, the difficulty of setting down requirements that will protect the investor despite anything the management may do, becomes evident. Therefore the idea of a reserve list has been developed as an alternative to give greater definiteness to substitution requirements, yet help rather than hamper the management. This device was already found in the Massachusetts Investors Trust and Incorporated Investors, mentioned in Chapter VIII, and in the Investment Trust Shares of the Investment Shares Corporation of California, created under Trust Agreement dated June 1, 1927. The Investment Trust of New York, Inc., has developed and emphasized the device.[6] Besides its primary list of seventy-five companies, its indenture names twenty-five companies, all listed on the New York Stock Exchange, in which funds derived from sale of a stock may be invested. In order not to keep the list too restricted, unlike its California prototype, which named a rigid list of fifty companies—twenty-five active and twenty-five reserve—three new stocks may be substituted on the reserve list every six months. The trust's executive committee must unanimously approve the change, as well as two-thirds of its board of directors. The change can be vitiated by objection from holders of 25% of the outstanding shares—extremely unlikely in view of the well known ignorance and apathy of stockholders. The substituted stock must be listed on the New York Stock Exchange and have paid dividends consecutively for at least the three preceding years. Diversification is achieved by limiting the holdings in any one company to 6% of the value of the unit.

The reserve list attempts to give flexibility, yet to tie sufficient "strings" to substitution to preserve some rigidity. It relies upon the thought of limited and slow change in the named securities, plus a system of complicated checks and balances, to protect the investor. Whether the device is really worth while in actual practice, seems open to question.

[6] The Colonial Investors Corporation of Baltimore, in an indenture dated Dec. 27, 1927, also uses the device of an alternate list of 41 shares in 41 companies.

SHORT TERM INVESTMENTS

One serious objection to the requirement that the trust invest the proceeds of the sale of a stock in another stock as soon as possible, lies in the fact that at the time of such sale, no other stock may be available, perhaps due to a bear market. Therefore several trusts permit temporary reinvestment, in place of merely keeping cash on hand. The Investment Shares Corporation, the Investment Trust of New York, Inc., Colonial Investors Corporation of Baltimore, and the Insuranshares Corporation trusts all do so. Between them they name time deposits or certificates of deposit, United States government obligations, bank acceptances and call loans, defining each class as necessary. Each of these classes is liquid, but Insuranshares adds securities legal for trust fund investment in New York, Massachusetts, Connecticut and Pennsylvania. Thus the hindrance due to illiquidity—found for example if New York and Massachusetts legal trustee securities are specified, of admitting real estate mortgage loans—is faced in its case.

The great, almost revolutionary significance of such a provision for short term investment is often not realized. Instead of tying the trust to slavish adherence to fixed trust procedure, it is given managerial discretion that may make the trust approximate the fund type. In auspicious markets common stocks may be taken up, and at the peak short term investments may be substituted to hold capital gains (though of course at the expense of current income), and when market conditions become favorable common stocks may once more be taken up. The unit may become merely a convenient block for building up sales, and be a symbol rather than a restriction. In short, the trust may become a restricted fund participation, rather than a fixed device, with the managerial restriction stated in a different fashion. Thus the counsel for Insuranshares, Col. E. B. Twombly, classes it with fund trusts rather than fixed trusts.

INCOME AND ITS DISTRIBUTION

As in the case of the fixed trusts, dividends are generally paid semi-annually to shareholders. The early trusts stressed the point that all the current income was paid to investors, no deduction whatsoever being made, other than for taxes or governmental charges, if any. But the original New England trust, it was later disclosed, deducted $400 per unit for the trustee's fee at the outset from the sum the investor paid, and invested this sum for its own benefit, merely using current income thereon to pay the trustee year by year, yet gave the trustee a lien on the fund if unpaid. Therefore, and possibly also in order to keep the spread down, subsequent trusts tend to pay the trustee year by year. The composite nature of the trustee's duties under the indenture is seen in a typical scale of charges allowed, as for example, under the A–1 indenture of the United States Shares Corporation:

Deducted from dividends received:

25 cents annually for each registered holder.

1% of income received respecting the deposited stocks (All stock dividends and other distribution, either in cash or securities, to be considered as income).

15 cents per check issued in payment of semi-annual distribution to certificate holders.

$10 annually per unit held.

Deducted from proceeds of sale of deposited stocks:

One-tenth of 1% of the proceeds of sale of deposited stocks.

In addition, other small stated fees exist for certificate issue, conversion, etc. The Investment Trust of New York, Inc., estimates trustee's fees at one-fourth of 1% per annum of the principal of the trust fund.

The same problems arise as to what constitutes current income, as exist in the fixed trust, with the added question of treatment of turnover profits. The original New England indenture emphasized current yield; the principal of the stocks was to grow unaided. It therefore provided not only that stock dividends and rights be treated as current income, but also the profit on turnover if that remained uninvested at the next dividend date. As in the case of the fixed trust, later organizations place more emphasis upon building up the principal. The revised New England indenture retained full shares received as stock dividends (as have several others) but retained the objectionable turnover provision. The first United States Shares bank trusts went further and gave the investor an alternative with respect to rights. Either he could have all rights sold and included in dividends (Series C–1), or he could have them held and exercised (Series C–2), but in both series stock dividends and turnover profits were added to capital. Its original series A common stock trust vested wide discretion in the management. It could decide how large a part, if not all, of the proceeds from sale of stock dividends and rights and turnover profits should be allocated to current income and how large a part to principal, making its decision prior to one month before the payment of the next dividend. If it wished to hold and exercise rights, it could employ cash in the principal of the units, or cash dividends received, for the purpose.

The more recent tendency has been to distinguish formally between the original principal of the fund and the turnover accretions to it from time to time. The latter are carried in a separate reserve fund or surplus account, notably in the United States Shares C–3 bank stock indenture and the Investment Trust of New York, Inc. Both build up the fund solely from the profits on turnover above the average cost of acquisition of the securities sold. It may be held either in specified temporary form, or used to acquire securities in general conforming to the requirements governing substituted securities. But the further purpose and disposition of the fund and its income differ widely. The current earnings from the former's reserve fund and, as far as necessary, the principal, are used to make the following semi-annual payments:

1. All taxes and other governmental charges, if any
2. The trustee's fees payable from it
3. Any balance of income of the fund shall then be paid into the income account of the units

The balance, if any, of the principal of the reserve fund shall be used to pay:

1. The Corporation's management compensation, for reserve fund management.
2. Into the principal of the units, a sum sufficient to make each, after paying the Corporation's compensation, not less than the value per unit six months before.
3. Into the income account of each unit, a sum equivalent to 50% of the total sums paid from the units into the Reserve Fund during the preceding six months (realized capital gains).
4. Into the income account of each unit, any sum necessary to enable the trustee to pay to shareholders total dividends at the rate of 5% per annum on the Corporation's asked price for shares.

In case the Reserve Fund has insufficient cash, but other property, the Corporation can order part of such property sold. Non-technically stated, half the turnover profits are distributed as current income; while the reserve fund and its income is used to pay taxes, trustee's fees, maintain the principal of the units, and serve as a dividend equalization reserve.

The requirements governing the Surplus Account of the other trust are far simpler. Its earnings are held in the account instead of going into current income of the fund. The Corporation in its discretion may order the trustee to transfer cash or securities from the surplus account to the principal of the units, for purchase of shares in reconstituted units. It may likewise direct the trustee to pay extra dividends from the surplus account. It is thus a fund designed to accumulate turnover profits at what may be termed compound interest, with extra dividends declared therefrom as the management decides.

Whether an intricate plan for a special surplus or reserve, arising from realized capital gains or turnover profits, is necessary, appears open to serious question.[7] The aim of building up principal is laudable; yet whether these items should be separated from stock dividends and rights, appears likewise open to question. The United States Shares trust grants complete discretion to the management in the handling of rights and stock dividends, while the Investment Trust of New York, Inc. requires merely that full shares received as stock dividends be retained. In other words, both follow the American policy of looking to rights, stock dividends and turnover profits for part of current income, in distinction to British trust practice.

[7] Unless there be other features, such as the fact that in the Investment Trust of New York, Inc., the investor converting his shares before the trust terminates, receives only his share in the principal of the fund, and the entire surplus account remains to be distributed among investors who hold shares at time of termination.

SALES METHODS

Unlike fixed trusts in general, managed list trusts were generally organized by men outside investment banking channels, and hence had to devote possibly even more attention to sales campaigns. Their literature and advertising has been as extensive, if not more so, than that of any fixed trust. A number of them have added retail sales departments in certain territories, at least in New York City. Both the New England Investment Trust and the United States Shares Corporation, prior to change in its control in December, 1927, were criticized in some quarters for high pressure sales methods and extensive mail order campaigns. They adopted the old fixed trust device of continuous or tap sales, which was not unwelcome from the financial angle, either, since many of the groups have been none too amply financed. The United States Shares group devised a so-called partnership group plan, whereby it sought to sell an investor with $1,000 or more three fold diversification through purchase of shares in its three classes of trusts—common stock, bank stock and Canadian bank stock—an extension of the idea that customers for one kind of trust are prospects for another. In March, 1928 this organization announced that it would at all times allow its stockholders to exchange their particular shares for those in any of the series established by it.

An unfortunate development in sales methods has been the instalment sale. The United States Shares Corporation sells on 30% down, the balance to be paid in seven equal and regular monthly payments, with 6% interest on the unpaid balance, the customer receiving interest on the shares. The certificate is not delivered until the shares are fully paid for. The New England Investment Trust had two plans other than for cash, both applicable to subscriptions of

100 shares or more. Its partial payment plan called for 20% down, the balance to be paid in eight equal monthly payments, interest and dividends as above. Its deposit account required a one-third deposit with subscription. The balance was payable within twelve months at the client's option, interest being due semi-annually on the unpaid balance. The shares were to be held as collateral.

The deposit accounts—obviously to be deplored as a substitute for margin speculation—were involved in the New England difficulties early in 1928. About the opening of 1927, the then manager of the trust "went short" on such contracts. He accepted the deposit, but did not buy the underlying securities and put up the share certificates as collateral for a bank loan. The situation was known in some quarters as early as the summer of 1927. In December the management of the trust changed, after its name had been changed the month before to New England Investors Shares, Inc. Holders of such contracts who tendered final payment were unable to obtain their certificates, and finally the Attorney General of the State of New York at the end of February, 1928 secured a court order enjoining the trust and its New York subsidiary from further sales, and a few days later the Federal district court in Boston appointed a receiver. The principal of the trust property behind full paid shares was unsuccessfully attacked by the receiver, and the present outlook for the deposit account holders is an almost total loss.

Only one trust of this type has departed in some ways from continuous sales. The Insuranshares Corporation puts out several series from time to time, each constituting a separate trust, but created under the same general plan. It affords much greater flexibility in buying securities advantageously for the trust. There is not the same pressure as the regular method brings, although theoretically the managed list trust can and should throw out the security which is "too high" at the time. Practically this cannot be done so easily in a bull market when all stocks are booming. The chief disadvantage of the series sales seems to be in breaking the trust up into a number of smaller trusts each having a somewhat different list of underlying securities.

MANAGEMENT COMPENSATION

The service which the depositor renders is the same as in the case of a fixed trust, with the added feature of management of investments during the life of the trust. The usual method of compensation is that adopted by the fixed trust, namely, an initial "spread." This has ranged from 9% of selling price for the Investment Trust of New York, Inc. upward. A New England computation, made as of July 27, 1927, is as follows:

Cost of 80 stocks (132 shares)	$9,994.81
Brokerage	140.00
Trustee fees for 20 years	400.00
Accrued dividends since July 1st	120.00
Our total fee for 20 years	970.19
Selling price of shares today	$11,625.00

The spread was figured on daily market price rather than cost, except in the case of a trust like Insuranshares, which acquired a batch of securities in advance against which it sold certificates.

The earlier practice was not to disclose the amount of the spread. The newer is to provide adequate publicity. The Investment Trust of New York, Inc., has the spread limited in its circular to 10% of cost, from whence it deduces the 9% of selling price stated in its circular.[8] The Insuranshares trusts have their spread roughly limited in the indenture, in that the deposited securities are stated and the number of certificates to be issued against them. The United States Shares Corporation in the indentures for its A–1 and C–3 trusts, requires the Corporation to file semi-annually with the trustee a statement of the average daily differential or spread between the sale price of the shares and the current market price of the underlying stocks, including odd lot and brokerage. The Corporation is required to print and distribute not less than 500 copies of the statement, and the trustee is authorized to disclose the spread to all inquirers.

In order to avoid another abuse, the New York indenture forbids the Corporation to buy stocks and sell them to the trust at a profit, also officers and directors to profit by the sale of stocks to or from the trust. The United States Shares Corporation A–1 and C–3 indentures permit the Corporation to deal with the trust only as broker, not as principal. Insuranshares Corporation puts in stocks at cost plus carrying charge at the rate of 4¾% per annum, and cannot deal as principal with the trust. The New England trust, it was already remarked, also retained the $400 trustee's fee for itself, and merely paid the trustee annually from the income thereof.

The same general pros and cons exist with respect to spread compensation as in the case of a fixed trust. Only they are heightened by the management feature. If the management is to get a fair compensation—commuting an annual fee during the life of the trust into a single initial payment—the trust property would be subject to

[8] It must advise the trustee of the amount, from time to time, at the trustee's request, but the latter is not required to request such statements.

considerable impairment. Even then, paid at the outset, the only pressure on the management to continue to manage lies in the hope of contained sales in future. Its interest is not tied to the interest of the investors. It would seem far preferable to separate sales compensation and management return; to pay the former at once, the latter only currently from income as received.

Such, in fact, is the plan adopted by two recent trusts. The United States Shares Corporation's A–1 and C–3 trusts pay the Corporation one-tenth of 1% of the principal semi-annually—4% in all over the life of a 20-year trust, which is considerably less than the usual investment counsel fee of one-half of 1% per annum. Even then, they pay in relation to size of fund rather than performance of management. Preferable appears the Insuranshares plan. It pays the investors all the initial return on the underlying stocks, and of the excess as time goes on, gives the investors 85%, the management 15%, while when the trust dissolves, the investors get 85% of the appreciation in principal, the Corporation 15%.[9] It accomplishes this by selling investors certificates representing units of one A share, of $20 par, plus one B share of no par, and issuing to the management (without any payment therefor) 18 B shares for every 100 A shares sold to the public.[10] The A shares represent the initial principal, the B shares the increase therein. The beauty of this device is that it separates sales cost (although it was the rather high figure of $10\frac{2}{3}$% above

[9] The initial rate fixed varied from 3 to $3\frac{1}{8}$% according to the series and of the balance at least 10 to 20% was paid annually on B shares. The management has discretion as to payment of extra dividends from reserve or current income (including turnover profit) and actually has paid out almost all the current earnings, relying practically entirely on unrealized capital gains for appreciation.

[10] The first two series were priced at par, subsequent ones above par so as to cover sales cost.

cost on the first Insuranshares issue and later 9½%) and management return, and makes the latter contingent upon performance. The management is tied into the trust in a pecuniary way and cannot get out entirely until it terminates, for its return upon principal appreciation will exceed its return by way of current income. Hence it will "carry on." Also the plan forces the management to buy for the benefit of the fund and at the best prices.

A curious variant is the plan of the Connecticut Investment Trust. For every unit of 52 shares of 24 companies (10 of them preferred stocks) deposited with a trustee, are issued 200 7% cumulative preferred trustee shares, and the trust agrees to maintain a market value of underlying securities of at least $2200. (It is allowed to substitute sound, readily marketable securities in its discretion under certain general conditions). The preferred is further protected by a dividend reserve consisting of 10% of the extra earnings on the posted securities above the preferred dividend. In addition, the trust sells separately to the public Class A shares, one for every preferred and the founders have the option to buy 100 Class B for every 200 Class A shares sold. Class A shares are preferred over Class B as to dividends up to 25 cents per share and in liquidation up to $7.50. Additional earnings and assets go two-thirds to Class A, one-third to Class B. All shares are non-voting. This is a unit managed list trust, with invitation to the public to participate on two different bases, and the management further trades on the equity against them. It is certainly a hybrid.

MARKETABILITY AND CONVERTIBILITY OF CERTIFICATES

The management supports the market for the certificates, and the same problem exists as in the case of the fixed trust. The market is likewise buttressed by the permission granted the holder of a unit to convert his unit into the underlying securities. Less than a unit cannot be converted, because the number of shares per unit is not divisible by two or any other number. Conversion gives him the right to receive his share of the appreciation in all trusts other than the New York, where the surplus account (representing realized capital gains) remains to be divided among those who hold certificates when the trust terminates. Insuranshares permits the holder to redeem quarterly, in cash or securities at the management's discretion, and subject to deduction of a set percentage or dollar figure, according to the earlier or later series.

The holder of less than a unit is specifically provided for in the two recent United States Shares trusts—A–1 and C–3. The Corporation deposits a certain cash sum ($15,000 and $5,000 respectively) with the trustee when the indenture is signed. This is to be used by the trustee to buy certificates from holders of less than 1,000 shares, who present them to the trustee, at their break-up value. The Corporation undertakes to keep the fund in the trustee's hands continually at $5,000. The underlying purpose is to avoid a situation such as existed in March, 1928 among holders of New England Collateral Trustee Shares. Dealers bid under the break-up value, so as to make a profit on the conversion operation. Some bid extra low prices in order to stampede frightened holders, while swindlers tried to trade holders out for worthless securities. The provision is an additional support to investors, and is hardly likely to become burdensome to the Corporation, since the general market will ordinarily take care of itself.

SELECTED REFERENCES

Insuranshares Corp. The Story of Insuranshares Trust Certificates, 1927, pp. 14.

Arndt, W. T. An American Type of Investment Trust, Bankers Magazine, August, 1927, pp. 151–164.

CHAPTER XI

SOME VARIANTS OF THE INVESTMENT TRUST

In addition to the "pure" investment trust, whether of the corporate or fund type, several other organizations exist which either combine other operations with investment trust business or else represent an offshoot of the investment trust. These are in a general way four fold:

1. Financing companies.
2. Companies designed to finance small industrial enterprises.
3. Bank holding companies.
4. Bank subsidiaries designed to carry on financing operations which the bank itself cannot undertake.

The present chapter seeks to describe and analyze the features peculiar to each, passing over briefly those aspects which are no different from current trust practice already mentioned. In particular is this true of the raising of capital, which is done mostly by sale of preferred and common stock. Instead, the differences exist largely with respect to the use made of the funds raised.

FINANCING COMPANIES

Continental investment trusts, while practicing diversification of holdings, are on the whole financing companies. "Their portfolios are rather in the nature of participations acquired to control, share control, influence policy or assist promotion, of subsidiary or related enterprises."[1]

[1] Robinson, p. 208.

They thus resemble the British financing companies, as do also in a sense most of the large Continental banks, due to the difference in banking practice from that prevailing in the Anglo-Saxon countries. Continental banks are tied into industry and participate directly in many leading enterprises. The financing companies on the continent, however, specialize to a greater degree than do the English companies in one line of endeavor, such as electrical, public utility or metallurgical.

In the United States the distinction between financing companies and investment trusts is much less clearly drawn than in England. The two organizations are newer and not so well understood, while the term "investment trust" has caught the popular fancy and is therefore widely used for sales purposes. Many an "investment trust" therefore has a large admixture of financing activity and might more properly be termed a financing investment trust. It differs from the holding company in that it has greater diversification and less control, being intermediate between that organization and the investment trust proper, and perhaps also in that it seeks a promotion as well as a directorial return.

Two groups of financing investment trusts exist today in the United States. The first largely represent an outgrowth of public utility holding companies, while the second have been organized especially to cater to the foreign field. While the Electric Investors, Inc., organized in 1924 by the Electric Bond and Share group, is rather close to an investment trust, the American Superpower Corporation, also formed in 1924, is interested in financing tho not in control or operation. To cite another instance, the North American Utility Securities Corporation was specifically organized in 1924 to take advantage of opportunities afforded to the company and its associated banking interests, to employ capital in enterprises other than its affiliated undertakings. The National Food Products Corporation, formed in 1926, represents an application of the same thought in another field.

The war time and early post-war foreign security enterprises described in Chapter III fall in the category of financing investment trusts. These include the American International Corporation, the American Foreign Securities Company, the Foreign Finance Corporation, the Foreign Bond and Share Corporation and the Overseas Securities Corporation. From 1924 on appeared a revival of interest in such plans. The United States and Foreign Securities Corporation, formed in 1924 by Dillon, Read and Company, Kuhn, Loeb and Company and the International Acceptance Bank, sought to undertake considerable German operations of an international commercial banking nature in addition to its regular investment activities. Other organizations have been formed subsequently to invest primarily in certain European countries—the Swedish American Investment Corporation, European Shares, Inc., the German Credit and Investment Corporation and the Danish American Corporation, as well as the Solvay American Investment Corporation. In each case strong American banking groups (Dillon, Read and Company and Lee, Higginson and Company have been especially active) participated with important foreign interests with which they enjoy close relationships. In addition several trusts exist whose investments are made by the direct intervention of Belgian financial groups, namely the American-European Utilities Corporation and the American-Belgian Financial Corporation, which have raised their initial capital privately and the latter of which is dissolving. In all cases, extremely broad powers exist as to the use of funds, whether direct or thru specially created subsidiaries to handle particular phases of the work.

COLLATERAL LOAN COMPANIES

Collateral loan companies represent a special form of financing company. Their work has been described by the Attorney General of the State of New York as follows:[2]

"They advance money to industrial or public utility enterprises on deposit of bonds, notes, acceptances, or mortgages. Funds for the purpose are raised by issuance of separate series of collateral trust bonds, each series representing a loan to one or more companies and protected by deposit of securities with a trustee as well as by the assets of the issuing company."

The Electrical Securities Corporation, organized in New York in 1904 as a subsidiary of the General Electric Company, is of this type. It holds stocks and mortgage bonds of electric railway, light and power companies, and is empowered to "acquire other bonds and stocks of similar companies and to pledge any such bonds or stocks owned by it to secure its successive series of collateral trust bonds." At various times it has issued its Collateral Trust Sinking Fund Bonds secured by the obligations of public utility concerns. Similar is the International Power Securities Corporation (formerly the Italian Power Co.) chartered in 1923. It likewise raises funds through the sale of various issues of collateral trust bonds. The collateral consisted respectively of acceptances of a Milan electric company, a first mortgage on the hydro electrical plant of the same company, bonds of a Parisian electric company and an

[2] Survey, p. 130.

obligation of a Turin gas company accompanied by stock purchase warrants. Thus these single securities were sold indirectly in the American market.

In a somewhat different field, the European Mortgage and Investment Corporation was organized under Delaware charter in 1925 by Lee, Higginson & Company and J. Henry Schroder Banking Corporation "primarily to finance farm mortgages in Central Europe." The corporation was authorized to issue its own bonds secured by obligations of European mortgage banks, municipalities and other governmental bodies, also railroads and public utilities. The bonds must be brought out in series and each series protected by separate collateral. The two series brought out were protected by deposit with an American trustee of land mortgage obligations of the Austrian General Land Credit Institution and the Hungarian Coöperative Society of Banks, each in turn secured by deposit of an equal amount of first mortgages on rural properties.

This type of enterprise is similar in underlying thought to the Edge Act corporations mentioned in Chapter III. It employs the idea of trusteeing collateral against which bonds are issued, and the capital, as in mortgage banks, merely supplies a small margin of protection for the bondholder. Hence the bond indebtedness of this type of financing company is often greater than in the investment trust proper. Nor, since the funds of the collateral loan companies are invested in a limited class of business, does the investor secure the wide diversification that has made the investment trust so acceptable in theory to the investing public.

FINANCING SMALL INDUSTRIAL ENTERPRISES

Difficulties are encountered in financing small established industrial concerns which are not experienced by the larger, well managed, and properly capitalized enterprises. The larger plants needing permanent funds ranging in amounts from $500,000 to $1,000,000, or more, usually find it a comparatively easy matter to make arrangements with investment bankers who will sell their securities to the public. The investment bankers, on the other hand, do not find it profitable or desirable to handle the financing of business houses needing from $25,000 up to $100,000. Methods of bridging this gap in the financing mechanism have often been discussed and special financing companies organized for this purpose have been proposed. Liefmann already mentions such a procedure, the essential idea being to broaden the market for established concerns' securities in this indirect fashion, rather than to finance entirely new enterprises.[3] In this way the cost as well as difficulty of financing would be considerably reduced, yet the investors receive a consistently higher return than elsewhere.

The problems faced in handling this class of business are several fold. Diversification is apt to be but moderate and the risk of loss thru one security "going wrong" correspondingly great. The securities acquired have no ready market, hence the trust cannot "get out" if it does not like the looks of things. Instead, it must rely upon its ability to bring pressure upon the management. Coupled therewith, it must provide a means for close and continuous supervision of the concern's operations, so that it can keep thoroughly informed and know at once when action is needed. But the small concern is apt to object to this supervision and potential control. Hence none of these plans has been conspicuously successful, due to lack of concerns willing to entrust themselves to it. The subsidiary of the bank which extends commercial loans to the con-

[3] Pp. 198–199.

cern would seem to be in a much more favorable position to undertake such operations, since it would not be "on the outside looking in."

Aside from interest displayed on the Pacific Coast, two groups in Baltimore have sought specifically to develop plans for special trusts whose primary business would consist of the financing of small established industrial concerns. The Industrial Securities Bureau, Inc., in 1926 proposed a plan of "group financing" for such concerns. Each group offering was to consist either of first mortgage bonds or first preferred stock of the component industrials with no prior lien or senior lien security ahead of the same, and was to consist "entirely of bonds or of stock, never mixed securities." The minimum acceptable group amount would be $500,000 if based on bonds or $1,000,000 on preferred stock. In the former at least three concerns must be involved, in the latter at least five concerns. The minimum individual component of a bond issue was $50,000, of a stock issue, $100,000.

The public was offered an opportunity to participate in this group financing through the purchase of "collateral trust certificates," ordinarily maturing serially in 15 to 25 years. The bonds of the industrial concerns were to be placed with a responsible trust company acting as trustee and against them were to be issued collateral trust certificates which were to be sold to the public. In order to insure their sale, each group offering was to be underwritten by "an acceptable investment banking house."

Supervision of the borrower and protection of the collateral trust certificate holder was to be ensured in the following manner:

1. Periodic audits of the books made and the resulting certified statements submitted by acceptable C. P. A.'s.

2. Periodic inspections and reports made by acceptable management engineers.

3. Provision made for the actual taking over of the management by the Bureau, or its associated management engineers, if any component company in any group offering defaults in sinking fund, interest or dividend payments.

4. Provision made for the liquidation of any such defaulting component company by the Trustee, and the satisfaction therefrom of the lien against the property provided under both plans.

The Bureau felt it safe to predict a money cost of from eight to twelve per cent including its fees, which would result in a very marked decrease in the cost of small loans.

The Mooney plan proposed in 1926 sought to accomplish a similar result in a slightly different manner. Under it the borrowing concern would be subjected to a very careful and thorough credit investigation. If found satisfactory a first mortgage bond would be purchased by the Parent Bond Company, which bonds would be guaranteed by the Parent Company both as regards principal and interest and then distributed to the public. In order to create a ready method of disposing of these guaranteed first mortgage bonds, the Parent Bond Company proposed to build up a large number of so-called subsidiary or affiliated companies in various cities and towns. The stock of these subsidiary companies would be jointly owned by the Parent Bond Company and local banks or business men, control being provided for locally. Before the Parent Company would buy any first mortgage bonds of a manufacturing concern, approval of the bonds must be made by a certain number of the subsidiary companies. Once the bonds had been purchased by the Parent organization, they would then be divided pro rata among the subsidiaries, who, in turn, would sell them to their own local customers.

The effect would be to provide a measure of local check on the concerns when securities were bought and a means of distributing them through these same channels.

A recently proposed ingenious variant requires the concerns financed to take out life insurance on designated individuals and thereby build up a protective fund.

Several other trusts carry on such financing as an incidental or subordinate operation. Thus the Continental Securities Corporation, incorporated in Maryland in 1924 by J. Henry Schroder Banking Corporation, Lee, Higginson and Company, Brown Brothers and Company and Clark Dodge and Company, upon organization invested about 50% of its capital in loans to corporations for periods of from 1 to 5 years, in each case with an option at a fixed figure on the stock of the borrowing company in an amount approximately equal to the amount of the advance. Domestically, we find the New Jersey Bond and Shareholding Corporation, incorporated in New Jersey in 1927. Initially its funds were invested in income yielding securities listed on the New York exchanges, and a minimum of ⅓ of its funds available for investment must remain invested in such securities. In addition to this regular investment trust portfolio, it may use the remaining ⅔ in what it believes the more remunerative field of a financing investment trust. It expects to take bonds or preferred stock of progressive New Jersey industrial enterprises of moderate size, purchased at a discount and retired serially, in each case with a bonus of common stock.

BANK HOLDING COMPANIES

The holding company, as a form of business organization, has had a very rapid development in the United States in recent years. Especially has this been true of the public utility industry. The advantages of the holding company in that field—in centralized control of the various operations as well as in finance—are well known, and it has long been prominent there.

A development of the last few years has been the bank holding company, especially on the Pacific Coast and in New York. Several of the more prominent have been organized as adjuncts of banks. They have undertaken financing and have held a general list of securities, as well as obtained control of banks and insurance companies. The pioneer has been Bancitaly Corporation, organized by the Giannini interests in 1919 with a capitalization of $1,500,000 to control the East River National Bank of New York. It has had phenomenal growth in assets, which reached $254,430,801 on January 26, 1928, and its stock thru stock dividends had upwards of 10 shares of $25 par value each represent one original share of $100 par value sold at 115 in 1919. It owns a substantial portion of the stock of the Bank of Italy, the largest bank on the coast, as well as control of the Bank of America of New York. It has substantial stockholdings in leading corporations and banks throughout the country and abroad, deals in preferred real estate and participates in syndicate underwritings. In the autumn of 1928, the Trans-America Corporation was formed to exchange its stock for that of the Bank of Italy and the Bancitaly Corporation.

Conspicuous likewise has been the Financial and Industrial Securities Corporation, organized in 1926 by the Jonas interests, which acquired assets and investments of certain predecessor syndicate interests. Assets had risen to a book value of $54,122,874 on Jan. 31, 1928. This company confines itself practically entirely to New York and vicinity. In contrast to Bancitaly Corporation, it specializes in comparatively few bank and insurance company securities and has also acquired control of industrial companies, which it has reorganized, refinanced and consolidated, then marketed the new issues at substantial profits. National American Company, Inc., at the opening of 1927 succeeded an organization founded by stockholders of the bank of similar name, which was later merged. Its assets on Dec. 31, 1927 were $24,495,022. Through subsidiaries and controlled companies it operates in mortgages, real estate, stock of banks, and operation of a chain of gasoline filling stations.

Besides these organizations, there are in the west the Marine Bancorporation of Seattle, with assets of some $52,000,000, and the West Coast Bancorporation of Portland, O. with a capital of $5,000,000; in the east, among others U. S. Financial Corporation of New York, the American Financial Holding Corporation of New York, Union Financial Corporation of America, the New Jersey Bankers Securities Company and the Bankshares Corporation of the United States. The last two control, respectively, several banks and a title and mortgage company in New Jersey, and several banks, as well as the Bankstocks Corporation of Maryland, which, in turn, owns various bank and insurance stocks. More recently, Pennsylvania Bankshares and Securities Corporation raised $3,000,000 thru Dillon, Read and Co., to acquire certain bank stocks, chiefly in six Pittsburgh institutions. Operating along entirely different lines in that they are designed merely for investment in financial securities, are two organizations controlled by the Bankers Financial Trust—the Eastern Bankers Corporation, formed in 1922, and the Bankers Security Trust Co., specially chartered in Connecticut in 1927. The latter is forbidden to exercise control. These are really specialized investment trusts interested in the securities of financial institutions.

The bank holding company is a product of the increased interest in bank and insurance stocks. Investors discovered these securities and bid them up sharply because of their presumed certain future growth in earning power and price. Issue of rights as stock was increased and rumor of mergers permitted further exercise of imagination as to future possibilities, especially of small banks. Widespread speculation developed, both in these securities directly and in them indirectly thru bank holding companies. Especially was this speculation marked, despite the opposition of its officers, in the Bancitaly Corporation traded in on the New York Curb, but chiefly on the San Francisco exchange. Loans were reputed to be obtained on this stock by borrowers outside banking channels at a rate of 12% per annum, plus 2% bonus. Finally in June, 1928, Pacific Coast holders of the stock on margin appear to have been unable to carry the burden longer, and large holdings were thrown on the market. From a high of 223, as compared with 136 at the opening of the year, the shares collapsed to 99⅞, altho subsequently recovering to around 120. Clearly such a speculative attitude towards bank and insurance stock is not in the public interest, and introduces a less desirable type of ownership, so that we must concur with the objections made by large New York City banks to the listing of their stocks on the exchanges and to the criticisms voiced at the Convention of the National Association of Supervisors of State Banks in July, 1928.[4]

A second criticism arises from the lack of publicity. Some of the companies publish only summary balance sheets, like those of a bank, which are extremely uninformative. Where a list of holdings is shown, no data are disclosed as to the basis on which they were acquired, which is especially desirable in view of the narrow markets and the additional

4 See the remarks of Geo. V. McLaughlin and Lester E. Shippe.

price often paid for control. What may happen is well illustrated in the case of the New Jersey Bankers Securities Company, which was investigated by the State Department of Banking and Insurance in 1928 and later by the legislative committee and then threatened with court proceedings by the Attorney General. A petition for a receiver was only denied when the president and certain other officers resigned. Secret profits were disclosed to officers and directors on sales to the corporation, as well as salaries which appeared high in relation to service rendered, and suit to recover them was averted only by payment to the corporation of $2,500,000.

RELATION TO CHAIN BANKING

The bank holding company is open to criticism, not merely from the point of view of corporate organization and control, but also from the point of view of banking organization. It arises because of our prohibition of branch banking and preference for small independent unit banks. In consequence of this prohibition, chain banking arose years ago, especially in the northwest, but also in other sections, such as the southeast. The managers bought a controlling interest in a number of banks or established new institutions and subscribed for a majority of the stock. These chains have generally been discredited. Failures have been heavy, due both to the fact that the members of the chain were generally located in a one crop agricultural section and to the natural tendency to employ depositors' funds for the managers' benefit.

Many feel that the bank holding company as we know it today is the current offspring of the old chains. They feel that it intensifies the problems with which chain banking had already made us familiar. Neither chain nor holding company is subject to direct governmental supervision; only the institutions under their control are supervised. And in both great opportunity exists for an unscrupulous and/or ignorant management to do harm. But the bank holding company in its greater size and its control of larger institutions, multiplies these opportunities. Unlike the old chains, which often had a personal basis, it approaches the public for substantial sums and the public asks no questions so long as the requisite profit is shown. Too often the bank holding company is developed by ambitious promoters or salesmen who seek to capitalize public interest in bank stocks. The result is a form of banking concentration which arises from purely selfish and alien motives rather than from a desire to render better banking service. Under proper management and control, it may be useful.

BANK SUBSIDIARIES

Some banks have formed subsidiaries to conduct various activities. Boston institutions, such as the National Shawmut Bank and the Old Colony Trust Company, have formed investment trusts of the kind already discussed. But in New York the banks have been smaller institutions in the mid-town section and they have changed the scope somewhat. Besides holding a general list of securities, they are to undertake financing operations that the bank itself is not permitted to handle, including second mortgage lending, and represent in a sense an expansion of its facilities. Illustrations are afforded by the Municipal Financial Corporation, the Brooklyn Lafayette Corporation, and the Claremont Investing Corporation, affiliated with banks of similar name. In most New York City plans, the new company was sponsored by interests prominent in the bank, rather than by the bank itself. This is the case e. g. with the City Financial Corporation, sponsored by men affiliated with the Bank of United States, the Hub Financial Corporation, sponsored by men affiliated with the Seventh National Bank, and the Manhattan Financial Corporation, tied in to the Times Square Trust Company. The usual set up is to have a preferred and a common stock—usually called A and B respectively—and to sell the former separately to the public, if participating, or in units with common if not.

The thought in forming these enterprises is of course twofold. On the one hand, stockholders and depositors afford a readily accessible source of capital, which can be obtained at low cost by offering them rights to subscribe to the stock of the new enterprise. On the other hand, the contact of the managers with the bank—in some cases they are the bank officers—affords an opportunity for various classes of profitable business. That these are real advantages, cannot be doubted. On the other hand, certain drawbacks exist. Publicity as to operations promises to be slight and these organizations are subject to no special supervision, as are the parent banks, while considerable opportunity exists for private profit in laying out the funds. In several cases, too, there has been some controversy over such profits in connection with the original stock issue itself. As yet, these organizations are of too recent origin—none were formed prior to 1927—to permit any conclusion as to the future of this variant of the investment trust idea.

SELECTED REFERENCES

Robinson, Ch. XII, Continental Institutions Akin to the Investment Trust, pp. 207–229; Ch. XIII, American Financing Companies, pp. 230–263.

Attorney General of the State of New York, Survey, pp. 130–132.

CHAPTER XII

INVESTMENT TRUST REGULATION. RETROSPECT AND PROSPECT

The problem of control of investment trusts remains to be considered. The British rely upon the standardized practice which has developed, and which has the force of custom and tradition, just as they do in other fields. In the United States the rapid growth of trusts, especially in 1927 and the first half of 1928, and the extreme diversity of practice, coupled with the high securities prices prevailing, caused considerable demand for public control. The present chapter seeks to examine the principal features of this question and the devices suggested to solve the problems raised. Having done so, the chapter undertakes further to say a few words in general conclusion, by way of explanation and evaluation of the movement, both as to present conditions and future outlook.

DEVELOPMENT OF TRUST REGULATION

The problem of investment trust control has attracted widespread attention within the past year. While various states had to consider the proper attitude to adopt towards these institutions under their blue sky laws—the laws themselves were, of course, silent as to trusts—it was not until the summer of 1927 that the matter came to the forefront of discussion. Then it was that the Attorney General of the State of New York began his investigation, which culminated in his "Survey" and later "Supplemental

Survey,'' containing the draft of a proposed bill for regulating the trusts. After going through several drafts, embodying considerable changes in point of view, the bill finally passed the State Senate, but died in the Assembly.

Other states either waited to see what New York would do, or else instituted investigations of their own. California, New Jersey [1] and Maryland, for example, investigated the trusts, and the first named, as well as Utah, adopted definite regulations to apply to trusts desiring to approach their citizens. Some eight other states have had a rather less definite formulation of their attitude towards trusts. In some, such as Nebraska and Wisconsin, the department is either hostile or ''not in a particularly receptive mood,'' while in others, such as Ohio, the earlier restrictions have been relaxed. In general, it may be stated, the requirements made vary greatly from state to state; what is commended as good practice in one may be frowned upon in another.[2]

This year the National Association of Securities Commissioners has devoted considerable attention to the matter. On its part, the Investment Bankers Association has likewise considered the matter at some length, and may be taken to represent in considerable degree the attitude of those engaged in the business, despite the inability of the latter to come together in an association of their own. Various public bodies, it may be noted, such as the Newark and Los Angeles Chambers of Commerce,[3] have appointed committees to consider the question and report thereon (done respectively in November 1927 and June 1928). This several fold interest, it is to be hoped, will result in clearer definition of standards and greater uni-

[1] Report of Attorney General reprinted in Keane, pp. 793–797.
[2] For data as to present requirements, see Keane, pp. 804–817.
[3] Report of former reprinted in Keane, pp. 797–800; report of latter in Commercial and Financial Chronicle, June 2, 1928, p. 3383.

formity in attitude towards trust practice than exists today. It is further to be hoped that this clarification will find expression in the six states or so, including New Jersey, Connecticut, Kansas, Maryland, Minnesota and Washington, which, it is reported, contemplate legislation during the winter.

AN ASSOCIATION OF INVESTMENT TRUSTS?

Evidently a considerable body of opinion exists in favor of governmental interference for public protection. The case for public interference bases itself upon the following facts. Trusts have multiplied greatly during recent years, and in 1927 the movement was accelerated. There were at the opening of 1928 well over 135 trusts, with a paid-in capital approximating $600,000,000. Great diversity of practice has developed. The present security prices are believed in many quarters to be high, and a parallel has often been drawn with English conditions about 1890. Fraud, however, is admittedly rare, and the object of the Attorney General of the State of New York, in fact, seemed to be rather to guide investment trust practice during a formative period. Some guidance, it seems to the writer, is highly desirable.

This at once raises the question, who is best qualified to undertake the guidance? The two alternatives immediately presented are (1) regulation by the public authorities, or (2) self help by the trusts themselves. The advantage of the former would lie in centralization of direction, except for the fact that under our system of state control 48 different ideals of investment trust operation might easily develop.[4]

[4] The recommendation of Geo. V. McLaughlin to the National Association of Supervisors of State Banks at its July, 1928 convention "that national legislation is preferable to state legislation because of the interstate character of the business," possesses much merit.

The differences introduced by the highly technical character of the field, such as definition of trusts, passage upon investment policy, etc. would undoubtedly further be supplemented in some cases, as in Pennsylvania today, by the arbitrariness that officialdom so often induces. Self help by the trusts themselves—regulation from within rather than without—has the advantage of generally more expert consideration, but presents the difficulty of inducing coöperation among the trusts.

On numerous occasions, effort has been made to form an association of investment trusts, yet always without success. Perhaps this reflects the diversity of types, and the diversity of groups interested in the field,[5] as well as a feeling that such a body is premature until time has had an opportunity to exercise its selective function and separate the sound from the undesirable. Much work, nevertheless, exists for such a body. It could aid in evolving standard practice and formulating policies. No less, it could help educate public opinion to select carefully from among the trust securities offered for public consumption. The various activities have been sketched in the Stanford University study as follows: "establishment of uniform accounting, devising a cost accounting system, derivation of standard costs, carrying on coöperative research and rendering other economic analysis service, publication of a manual of investment trust securities, presentation of investment trust point of view to public regulatory bodies, conduct of legal research, rendering advice on various state regulations, conducting marketing research for investment trust securities, advising in regard to financial advertising, and conducting coöperative investment trust advertising campaigns in leading periodicals." Formation of such an

[5] Hence some proposals have looked towards formation of an association in a more limited field, such as among the fixed trusts.

association of investment trusts embracing the stronger groups in the field, and perhaps allied with the Investment Bankers Association, would be a great help.

PROPOSALS OF THE ATTORNEY GENERAL OF THE STATE OF NEW YORK

Undoubtedly a degree of public control, aided by the co-operation of the investment trust industry, represents the ideal situation. But this at once brings up a further question: what should be the object of public regulation? Two principal theories exist:

1. The Attorney General of the State of New York proposed to have the Banking Department of the state pass upon those who wish to form companies under the name "investment trust" and upon their structure and plan of operation, as well as to supervise their operations when once approved and active. A corporate trust, run by reliable people and adequately supervised, could conduct its operations without publicity so far as the public is concerned, but a fund type trust, similarly supervised, would be further required to make specified disclosures to the public.

2. An alternative bankers' proposal, favored by the New York group of the Investment Bankers Association, was that the Attorney General's powers to prevent fraud be broadened. Publicity of operation would give the public the data on the basis of which to judge trusts, whether of corporate or of fund type. A similar preference for fraud acts, with broad powers of investigation, as against the blue sky type of legislation, was expressed by the board of governors of the Investment Bankers Association in January, 1928 and by the Association's Investment Trusts Committee in its June, 1928 report.

Briefly stated, the Attorney General proposed to add a section to the state banking law providing for the incorporation of investment trusts and requiring the Superintendent of Banks to pass upon applications to form trusts, as well as to supervise the operation of such trusts. Foreign trusts could do business in the state under the proposed legislation only if they were licensed and conformed in all essential features to the requirements laid down for trusts organized in New York State. The original draft sought to define the term "investment trust" and to require all companies conducting such a business to come under the law. But the final draft, besides relaxing standards, became purely permissive, not regulatory in character.[6] Those who wished to conduct the business without violating the sanctity of the name "investment trust" might do so to their heart's content. Thus the whole object of the legislation changed, and it did not seek to bar, as did the original legislation, the high pressure salesman, if not actual sharpster, who sought out the small investor as his prey. Restraint of him was left to the Martin Fraud Act already on the statute books. And over the trusts electing to come under the new law, the banking department was given but moderate control; it might not anticipate difficulty and take preventive measures, but was to wait until trouble had actually occurred.

The original proposals of the Attorney General relied upon the state authorities to protect the public. This is a great responsibility, particularly in view of the lack of standardization of trust practice existing today and the lack of clear understanding of many features of trust operation. Where to draw the line between matters of strictly

[6] The first draft is given in the Attorney General's original Survey, a revision in his Supplemental Survey, and the final form in Keane, pp. 773–783. The successive drafts were worked out in coöperation with a number of trust attorneys.

internal business policy and those of general public concern, it is not easy to determine. It moreover involves lodgment of great power in the hands of the supervisor. Essentially, it represents the blue sky type of legislation, applied in one particularly difficult field. The experience of other states with such a type of legislation has shown its many problems and pitfalls.[7]

Moreover, it should be considered whether regulation of this one class of institution suffices, or whether the entire body of newer financial institutions which have arisen in the last few decades alongside the regular banks should not be studied, their interrelations, and the necessity and desirability of control of each. Finally, should not the several present-day investment institutions be considered, and the field of service of each, as a prelude to control? The "living trust" of the trust company, the investment counsel and the investment trust are in certain cases undoubtedly competitors for the same investor's favor, yet no clear recognition of how they fit into the picture with one another exists today. In short, the problem is far broader than that of mere control of one class of financial institution, and has widespread ramifications that should be studied carefully before any regulatory legislation is prepared.

When the Attorney General's final, as compared with his initial draft, is considered, it is seen to adopt a third theory. Evidently the thought therein was to create model trusts in New York which would automatically be preferred by the investing public to those not organized or qualified as "investment trusts" under the state law. These trusts, he apparently believed, would come to occupy such a preferred position elsewhere, as well as in New York. Of course such reliance beyond the borders of the state upon

7 Geo. V. McLaughlin opposes putting the trusts under the banking department, since their activity falls under the general securities business, rather than deposit or trust banking.

the sound discretion exercised by the New York authorities would correspondingly increase their responsibility. Whether the preferment shown by investors would be so widespread as to force trusts either to come under the law or else go out of business, seems open to question.

THE BANKERS' ALTERNATIVE PROPOSALS

The bankers had a different approach. They sought to amend the Martin Fraud Act[8] by requiring publicity of trust operations. In case that publicity were not forthcoming, the Attorney General might then take proceedings against trusts that withhold information or present it in a misleading fashion, just as he already can with respect to fraudulent concerns. These proposals were never embodied in a formal bill, although it was understood that one was in preparation.

The thought of the bankers was that publicity provides the most practical and wholesome restraint upon any investment trust. They recognized the difficulty of providing by legislation the sound management which spells success for the enterprise. They therefore proceeded on the theory that the citizen has a perfect right to select an investment medium, so long as he knows what he is doing. The state merely guards against offer of fraudulent issues and issues that are misleadingly presented. The investor should realize how the trust proposes to make money, how this money is to be divided between the organizers and himself, and how much is to be retained in the trust instead of being distributed currently. In short, publicity is desirable. Investment trust executives' discussions and general public education would be relied upon to evolve sound practice, while public opinion would control. Undoubtedly an op-

[8] Reprinted in Keane, pp. 784–793.

portunity would exist for creation of an active and intelligent public opinion on investment trust matters, whose discussions would be choked off under the Attorney General's first type of legislation. The investment trust is no hothouse flower, and could well profit by this discussion.

A further explanation of the bankers' proposals has been advanced in various quarters. As security dealers, they are interested in an open market for securities in New York City. Licensing of a certain class of securities might well afford an entering wedge for more general blue sky legislation, which would have a restrictive effect upon the market. Hence it has been suggested that their interest has been broader than in the mere investment trust phase, and that they have had in mind the possible effect upon the entire machinery of security distribution.

The two points of view—public regulation vs. publicity—are exemplified in part in the Utah and California regulations. Utah requires that a portfolio list and record of trading operations be submitted to the Securities Commission, but California in addition to setting certain standards of practice to which all trusts must conform, requires that the entire portfolio (owned and dealt in) be disclosed to shareholders semi-annually. The California Commissioner states that the future development will be along the lines of publicity requirements. Incidentally, the Utah requirements further illustrate the difficulty encountered in framing such regulations. A "discretionary or trading type of trust," presumably whether corporate or fund in structure, must notify the Commission and obtain its approval before a substitution can be made in the portfolio, if it wishes to continue the sale of shares, submitting a statement "setting forth consistent reasons for such substitutions." Continuous selling would seem practicable in that state largely only, if not solely, for fixed trusts.

RETROSPECT

The salient feature that impresses the student of investment trusts in the United States is that the development is not the result of mere chance, much less of the mere self interest of promoters. Instead, basic economic conditions account both for the rise of the trust and the lines along which it has developed.

In general, the investment trust arises in nations where a surplus of capital exists relative to the opportunities directly afforded investors to lay out those funds. Such was the case in England seventy years ago, such is the case in the United States today. And our problem is heightened by the greater diversity of securities available, and the development of a newer and more scientific investment technique to meet that situation, yet a tool for specialists rather than for the rank and file.

The extreme diversity of trust practice found today in the United States results in part from the suddenness of our change from debtor to creditor nation and the corresponding rapidity with which the institution has developed. Add to these the rapidity of American economic growth in general, and the temper of the American people in insisting upon progress and change, rather than upon stability. When due emphasis is laid upon these factors, the course of the American movement is readily apparent. The British, on their part, had a much more gradual development. They underwent the flurry of the late 80's and early 90's, learned their lesson, and settled down to conservative adherence to those customs which experience sanctioned and avoidance of those that it condemned. The result was a crystallization of practice.

These factors account, too, for the fact that our "British type" corporate trusts today resemble the British trusts chiefly in nonessentials rather than in fundamentals. The resemblance is superficial rather than basic. This statement, it should be noted, neither condemns the one nor praises the other per se. American trust structure reflects, in its trading on the equity accompanied by its thin margin of junior money and its dressed up security forms, the tendency to pay the successful promoter heavily for his services, as well as the taste of the public for fancy securities with a speculative flair—"business men's" investments, rather than the straight forms. To make the junior securities worth something, the trusts must trade; they cannot buy merely for long term investment. The investment policy cannot rely merely upon slow steady growth, plus one per cent more on the invested funds than is paid the holders of the senior securities; the immediate return would be inadequate and sorely try the investor's patience. Hence he is tempted by the lure of turnover profits. These profits are made with the help of statistical and other aids which more scientific business method has developed in the field of investment. But these profits must be shown in the earnings statement; they cannot be concealed. Hence they are treated as current income, and from them come largely the dividends on common stock and the surplus and reserves built up. In short, capital structure, investment policy and accounting practice in the United States go hand in hand, and reflect underlying economic conditions.

Contrast with this staid British policy. British trust organizers no longer trade on the equity; more conservative capital structures and straight securities are used. Especially since they raised such large amounts of senior capital years ago at low rates, they can pursue a conservative long-run investment policy, with turnover incidental. And they face no pressure to show turnover profits, which they calmly employ as hidden reserves in writing down the figure at which they carry their portfolio. The result is to have a small group of directors administer funds in a sort of trustee fashion.

If the American investor wants a long run investment policy, in fact, he has to turn rather to one of the list trusts, whether fixed or managed. This is generally restricted in scope, either growing with the United States or with one industry, such as banking, believed to possess special possibilities. Hence he lacks the widespread diversification the British practice, which the corporate trust at least tends to give him.

EVALUATION

The investment trust renders a distinct service. It is no mere parasite, "living on the honey made by others," as a British critic claims. To change the figure, it "is no cancerous growth on the body financial to be excised by official surgeons, but a natural and perfectly legitimate development."[9] Despite the slogan of security dealers who wish to sell their customers continually, "Be your own investment trust," the investment trust is superior in its investment knowledge, skill and sources of information, coupled with its general attitude of doing the utmost for the investors associated together in it, and its use of larger funds.

The investor, it is only fair to say, has in general in the United States paid liberally for the service rendered. Trust organizers are only human, and they have exacted the full market price. Both costs of selling and promotional return

[9] Conner, T. B., Investment Trusts and State Supervision, address before National Association of Securities Commissioners, October 1927.

through security holdings have been heavy.[10] But for this the general American practice is to blame, rather than any special machinations in this field. Our system of security distribution is notoriously costly, while our system of permitting anybody freely to start in business and then rewarding the successful ones heavily, likewise places a considerable burden on the community.

Rendering a useful service to the community, and one supplied by no other institution, the movement has made great progress. But it possesses, nevertheless, certain elements of weakness. Fortunately the latter represent largely the growing pains incident to any such rapid development. They may be summarized under the following heads:

1. The existence of a considerable number of small, weak trusts, organized under boom conditions. A few trusts are undoubtedly dishonest; somewhat more are organized by salesmen with little knowledge of finance; and still more by well intentioned incompetents with inadequate backing.

2. The rearing of corporate capital structures which fully exploited the remarkable profit making possibilities through turnover of portfolios existing during the rapidly rising security markets of recent years. This creates a considerable burden of charges, whether fixed or contingent, the margin above which is supplied largely if not entirely by turnover profits.

3. The existence of a speculative attitude, rather than an investment attitude, towards investment trust securities on the part of the public. With a lack of understanding of trust management problems, and looking only to the records of past years in appreciation, any disillusionment in future is likely to cause sharp revulsion from the trusts as a group.

10 With the exception of some fund type trusts that in general do not cater to the small man.

4. Variety of trust practiee with respect to almost every phase of operation. This makes it difficult to judge various trusts, and makes many represent a eurious eombination of virtues and viees. It likewise means that those most intimately informed have as yet reaehed no agreement as to the field of use of various practiees. While no single form of trust or poliey is perhaps ideal, and various trusts are adapted to various needs, surely no sueh profusion as exists today is either neeessary or desirable.

5. Lack of understanding on the part of the general publie. An uncritical snap judgment is apt to espouse the bad, tempted by catehwords and rash promises, while condemning the good, honestly prepared and presented in more conservative fashion. At the same time, it is apt no less to be suspieious, and, where unjustified, easily stampeded.

PROSPECT

The trusts are undoubtedly today entering a testing period. The future eourse of security prices is no open book, and the general eonsensus of opinion antieipates mueh more diffieult investment problems than obtained in recent years. At the same time, they should emerge greatly strengthened, better understood by themselves and by the publie at large. Despite the hazards of propheey, we may expect to see several developments:

1. A seleetive proeess among the trusts, and coneentration. Failures are not likely to be very extensive. Quiet departure will be more frequent, or eonsolidation as a graceful means of exit in an unequal struggle. Hopes of many investors will undoubtedly not be realized. In the faee of this, large well-run trusts are likely to strengthen their position and a distinet body of skilled and reeognized investment trust managers emerge. Despite these individual

readjustments, the trusts as a group should continue to grow—after the present period of consolidation of position—and become firmly intrenched as a powerful factor in our investment mechanism.

2. A greater standardization of trust practice, as devices become better known. This has to do both with respect to structure, investment policy, and distribution of income. Unsettled points, such as the legal aspects of trust "indentures" and status of parties thereunder, mentioned in Chapter IX, will be clarified. Special investment theories will be tested, in particular the common stock theory. It seems likely that greater emphasis will be placed upon an investment policy that looks less to turnover, that corporate capital structures will be somewhat strengthened and that promotional returns will become more standardized and decrease. In other words, somewhat of a "toning down" may be anticipated over the years. In this process, a better understanding of the real field of service of the investment trust will develop, and of its relation to older savings and investment institutions.

3. Better understanding by the public and more careful and intelligent selection of investment trust securities. This natural development is highly desirable and will constitute a factor of added strength in the movement.

What is needed to help along this progress? Three lines appear:

1. A measure of regulation, coupled with assumption of responsibility by trust managers. Exactly what lines legislation should take is as yet unclear. While repressing fraud and misrepresentation, it is desirable to "go slow" on other features until technique is much more clearly understood than it is today. The progress of the trust movement depends more largely upon the trust managers than upon regulation. In proportion as they are honest, competent

and hard working, with definite realization of the responsibility placed upon them—to the movement as a whole, no less than to the individual investor—just so far will the trusts succeed. That responsibility should be emphasized.

2. Widespread publicity. The more facts of trust operation are broadcast, the better will trusts be understood. Coupled with the making available of data, should be systematic education of the public in investment trust fundamentals.

3. Careful study by and of the trusts. The imperfectly understood technique of today will tend to clarify itself as time goes on. But the process can be greatly accelerated by systematic and scientific study and the several devices perfected.

SELECTED REFERENCES

Fowler, Ch. XVII. Public Regulation, pp. 226–239.

Conner, T. B. Investment Trusts and State Supervision. Address before the National Association of Securities Commissioners, Oct. 1927.

National Association of Securities Commissioners, Committee on Investment Trusts, Report, August, 1928.

Investment Bankers Association, Committee on Investment Trusts, Report, October, 1927, reprinted in Keane, pp. 800–804. Investment Trusts Committee, Report, June, 1928; Report, October, 1928.

Attorney General of the State of New York, Survey, pp. 96–123, reprinted in Keane, pp. 718–733.

—— Supplemental Survey, pp. 25–32, reprinted in Keane, pp. 754–759.

—— Final draft of proposed bill, reprinted in Keane, pp. 773–783.

Martin Fraud Act (New York), reprinted in Keane, pp. 784–793.

Attorney General of the State of New Jersey, Report, reprinted in Keane, pp. 793–797.

Newark Chamber of Commerce, Report, reprinted in Keane, pp. 800–804.

State Regulations, etc., governing or regarding investment trusts, Keane, pp. 804–817.

McLaughlin, G. V. Address before National Association of Supervisors of State Banks, July 1928.

Robinson, Ch. XVII Outlook for Investment Trusts in the United States, pp. 332–347.

Speaker, Ch. VII, Summary and Conclusion, pp. 99–103.

Williams, Ch. XII, Outlook, pp. 90–94.

Robinson, L. R., Investment Trusts—Prospect and Retrospect—An Address before the Southern Group of State Securities Commissioners. Bankers Magazine, Aug. 1928, pp. 191 ff; Sept. 1928, pp. 333 ff.

THE END

INDEX

Investment Trusts and Related Companies—American

Investment Trusts and Related Companies—British
(Including Bankers)

Banks, Investment Bankers, Security Dealers, and Investment Counsels—
American

AUTHORS' INDEX

(Exclusive of references made in bibliography and lists at close of chapters)