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INVESTMENT
A NEW PROFESSION



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INVESTMENT

A NEW PROFESSION

BY
HENRY S. STURGIS

New York
THE MACMILLAN COMPANY

1925

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Set up and electrotyped.
Published April, 1924

Printed in the United States of America by
THE FERRIS PRINTING COMPANY, NEW YORK.

FOREWORD

The publishing of this book at this time seems to me particularly appropriate, as its subject has a direct bearing on problems that have engaged our attention since the close of the World War.

The public's interest in securities was stimulated by the active campaign for the distribution of Liberty Bonds. A few score thousands of holders of securities grew to well over twenty million and the securities now traded in cover the whole field of our business life. These securities reflect the enormous costs of war and they represent our efforts to restore the economic structure destroyed by the war. They are the evidences of property and debt, upon which our credit structure rests, for securities are the most readily negotiable, the most liquid of all expressions of our national wealth. Bank notes, bank deposits, foreign exchange, as well as securities, are merely bookkeeping devices to facilitate credit. Doctor Rudolph Binder, head of the Department of Sociology of New York University, is quoted as saying, "Lack of honor among business men is the chief reason for their work not being included among the professions." I do not know on what Doctor Binder bases his conclusion. Credit presupposes honesty, and ninety-five per cent of the business of the country is done on credit.

Unless the vast majority of business men have the quality of fair dealing as well as keen discernment, this country could not have grown and prospered.

There is absolutely no secure investment for capital. Capital is always held at risk. The only capital which is safe is capital spent in the interest of the public. The consolidation of capital in the form of stock companies is of service to the entire world. The stock company provides us with food and lodging and coal and light and clothing; it insures our lives and dwellings, and makes possible the existence of our savings institutions. Who owns this capital? An analysis of the distribution of securities of any of our great corporations will demonstrate that the people and not the so-called interests are their real owners. The share-holders in the Pennsylvania Railroad, over a ten-year period, increased from 63,000 to 133,000; in the United States Steel Company, during the same period (1910-1920), the share-holders increased from 22,000 to 104,000; and in the American Telephone and Telegraph Company from 35,000 to 120,000. These three companies are typical of American large scale companies as a whole. The first is a railroad, the second is an industrial company and the third a public utility.

The demand often heard, that the public should exercise more control over these large scale corporations, suggests the extension of practical politics into the field of business. But a sounder method of insuring public control is through the gradual distribution

to all classes of the shares of these companies. In this way, the public gains control by actual ownership rather than by experimental legislative programs. The responsibility for the proper distribution of securities rests largely with the investment banker, and in emphasizing his obligation and insisting on its importance, Mr. Sturgis has performed a genuine service.

SEYMOUR L. CROMWELL.

Office of the President
New York Stock Exchange,
Jan. 10, 1924.

PREFACE

Attention is constantly called to the vast amount of money which is lost annually through the purchase of fraudulently issued and worthless securities. By means of oil stocks alone it has been estimated that trusting people have been parted from hundreds of millions by those who had little, and too often nothing, on which to warrant the issue of securities and their sale for good hard cash. It is also true that many millions are lost each year through the purchase of securities which have been issued in good faith but, because the promoters have been lacking in business training or even ordinary foresight, the worthlessness of the stocks or bonds has been very quickly demonstrated. There is further unfavorable comment upon the fact that, in far lesser degree, large sums are annually lost because securities have been issued in an improper manner and without sufficient care by investment firms of the highest grade and reputation.

There are certain very fundamental reasons for this situation. In the first place, there is a very general lack of understanding on the part of both investors and bankers as to just what are the economic functions of an investment firm, where it fits in the life of the community and how it helps to run the economic machine. Secondly, the buyer of securities, with the rarest exception, does not recognize that the investing of money requires a specialized knowledge and train-

ing probably as vast as that of any profession. And finally, due in part to the failure of the investor to see how intricate a matter the proper placing of funds has come to be, the investment business has developed in such a way, and the competition in it has become so keen, that the placing of securities has become too much a matter of selling ability rather than of judgment or value. It has followed that the banker has not been able to give the investor the professional service to which he is entitled, and in most cases is not properly equipped to render such a service. The inevitable consequence is that the buyer of securities has not that measure of confidence in his banker without which the essential co-operation between the two can not be attained.

Where there is so much of the personal element in a business and where the constant dependence upon foresight is such a large factor, it is manifestly impossible to eliminate losses in securities. But it does seem possible to cut them down materially, and the pages that follow are devoted to outlining some proposals along this line. In order to make the situation as clear as possible it has been found necessary to outline briefly what seem to be the economic functions of the investment banker, and to point out broadly the factors which should be considered in choosing an investment from the professional point of view. There is given also a summary of how the investment business is now done, and how, with its present organization, it is difficult for the investor to have the complete

confidence in his banker which he should have. Suggestions are then made as to the organization necessary on the part of the banker so that he may obtain that confidence so freely given to a man in a profession.

It may be found that some of the statements made are trite; it will probably be found that some of the suggestions are idealistic; it is probable that no single individual will agree with all the conclusions; but if, as a whole, they result in thought and discussion being brought to bear upon what is admittedly a real problem, it is possible that some steps may be made toward the ideal, and some of the wasted millions be saved for the advancement of economic progress.

It is proper here to express my appreciation for the help received through discussion of many of the problems with friends and associates, and to acknowledge the use of material contained in the articles of Arthur Stone Dewing, Associate Professor of Finance in the Harvard Graduate School of Business Administration, published in the Harvard Business Review. Especially am I indebted to the President of the New York Stock Exchange, Mr. Seymour L. Cromwell, who gave me the encouragement necessary to undertake the task, who made available to me the comprehensive report of Mr. Andrew Ten Eyck, a member of the New York Bar, on the workings of the British Companies Acts so far as they relate to the issue and distribution of securities in England, and who has done me the honor to make use of some of the passages which will be found in subsequent pages.

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THE ECONOMIC FUNCTION OF THE INVESTMENT BANKER

Any discussion of the relationship between the investor and his banker or broker must be preceded by a fairly definite understanding as to just what their economic functions are, and what place they fill in the general organization of industry and trade. That there is some question in the minds of many people as to the value to the nation of security dealers and brokers is well shown by the widespread feeling throughout the country in regard to "Wall Street." This dislike and fear of the financial community has been bred by the activities of a few dishonest men whose escapades have been widely reported, and the crude ideas thereby created have been fostered by the yellow press. There are many who hold that the dealer in securities, or the stockbroker, performs no service to mankind and that he is in the nature of a parasite, a useless appendage to the economic system. Those who most prominently support this view are, of course, people of the radical type who abhor anything which has to do with capital. To such men, one who deals in securities has no real value and should be done away with, for apparently he adds nothing to the world's wealth and happiness and merely preys upon others, extracting ill-gotten gains and rendering

no service. Not only do radicals so express themselves, but, unfortunately, such views are surprisingly often expressed by otherwise intelligent business men whose crude ideas of "Wall Street" have perhaps been strengthened either by finding some piece of financing costly beyond expectations or by having had an unfortunate investment experience with someone in whom confidence should never have been put in the first place. Altogether there is wide misunderstanding as to the economic functions of these dealers in securities, so that some explanation of their place in the industrial life of the country may not be amiss and may help toward a realization of the relationship existing between security buyers, investment bankers, and industry. After all, much of the controversy between various parts of the economic machine arises from a lack of knowledge of the function which each is intended to perform.

It is probable that, on the whole, even though many thoughtful investors and business men resent the necessity of paying commissions or profits in the purchase and sale of securities, such men recognize the economic value of the investment banker and the stock broker. Their growth has been more or less coincident with and the direct result of the tendency toward the corporate form of doing business. In the olden days, when industry consisted almost entirely of small units, individuals, or a small group of individuals, could themselves raise enough money to start business, and their growth usually came from the reinvestment of

their own earnings. Gradually, however, as business grew in size, it became necessary to go out of one's immediate circle in order to acquire the larger sums called for. This was difficult to do so long as each partner in a firm was responsible for its whole indebtedness, because men hardly cared to assume such responsibility without being in direct and close touch with a concern's affairs. With the coming of the corporation and the limited liability of shareholders, the obtaining of money for enterprises in which the shareholder did not take an active part became easier. The larger the units needing money became, the more widespread became the sources from which funds were obtained. So arose the necessity of a specialist in the gathering of funds for use in industry, and to-day we have, as an essential cog in the economic machine, the investment banker, a person or organization so equipped and so skilled in the art of mobilizing funds that he can gather innumerable small sums into vast amounts. And, be it noted, he has become responsible for seeing that the sums so gathered are directed into channels where, either through increasing productivity or through facilitating production, they will earn a return commensurate with the risk involved.

Coincident with the growth of the corporate organization and its limited liability came also the ability to transfer one's interest from one concern to another or to get out altogether. This involves the necessity of finding a buyer for the interest to be disposed of and a seller of that desired. The difficulty of doing

so at any particular given moment gave birth to the stock and bond broker who made a specialty of finding buyers and sellers of securities and of bringing them together. The final step was the organization of the brokers into associations so as to facilitate the meeting of buyers and sellers. In this country the New York Stock Exchange has become the leading meeting place, and there day after day large sums of capital flow freely from one industry to another. The difference between the functions of the investment banker and the broker might then be said to be that the former mobilizes small sums into large, and that the latter facilitates the transfer of these funds into and out of securities or from one to another. Incidentally, it is not unusual for one person or firm to act in both capacities, although, of course, it should not be done at the same time in the same transaction. In the United States, we are used to large quantity standardized production. With a limitation upon immigration and its consequent effect upon the labor supply and wages, it is probable that the tendency toward reducing costs through the method of large quantity production is going to be given further impetus. It can be expected, therefore, that larger sums than ever will be required to bring this about, and that the banker and broker will be called upon more and more and will be found even more essential to the industry of the nation than they have been in the past.

It is now beginning to be felt that both the investment banker and the broker must take upon their

shoulders another function which bids fair to become more important than that outlined above. The increasing use of the corporate form of industrial organization has in recent years brought upon us such a flood of securities, both stocks and bonds, and so many of these securities have been improperly issued, that the investment of money, a complicated problem in any case, has become more and more involved. It is becoming necessary, therefore, for those who make a practice of dealing in securities to assume the care of the capital funds of their clients and customers. It will be said that this is done now. Unfortunately, it must be said that, although every banker and broker in the country makes a practice of maintaining that his primary interest is that of the investor, the present organization of the investment business makes it exceedingly difficult for this to be as true as it should be, and the fact that investors generally do not give their bankers the same co-operation which they give to their lawyers and doctors points to the truth of the statement. The care of capital funds is a trusteeship, not only for the benefit of the owner, but also for the good of the community. Capital wasted is lost to every one and provides nothing for production or the employment of labor, nor adds in the slightest to the well-being of the world. Capital is the result of hard work and sacrifice, and its accumulation is dependent upon the savings of the community. It is a pity, therefore, that it should be handled recklessly or carelessly and not given a full chance to obtain the income due, which

means a fair "pure interest" return and income in addition corresponding to the risk involved. And further, there is sound reason for believing that some attempt should be made to maintain the purchasing power of the investor's income. All this will be covered in more detail later, but, in the meantime, it should be stressed that the present organization of the investment business prevents the banker from invariably giving first consideration to the investor, and that he has not equipped himself to accomplish this purpose, except in rare cases.

No one questions the importance of the commercial banks. When it is realized that these deal on the whole with liquid funds over short periods, the importance of investment firms which deal in funds to be permanently placed in some industry or corporation becomes more evident. To the latter, the element of foresight and care is even more important than to the ordinary bank, yet they are not generally so well organized as the commercial banks and are less able to minimize the chances of error.

It is essential to the proper performance of the services of an investment banker that he be endowed with extreme honesty and dependability, that he have a wide knowledge of general business and economic conditions, keen foresight, sound judgment, a high degree of financial skill, and the willingness to assume great responsibility. To attract into this business men fulfilling these requirements makes necessary the promise of an excellent return, either in profits and

commissions—or fees. This is most important to bear in mind if we would have the capital necessary for productive enterprise mobilized with the least loss to the nation, placed where it will do the most good, and properly conserved. Certainly, when the decision as to the raising of millions of dollars means the question of their possible employment productively or their waste, it becomes apparent that it is worth much to the country to have such decisions left to those who can be depended upon to make the fewest mistakes, and to encourage such men to enter the business means the holding before them the hope of great reward.

The problem before us is, therefore, the study of investment banking and security brokerage with a view to seeing whether it can be organized along such lines that both the economic functions of the investment banker can be fulfilled, to assure ourselves that the return to be expected will entice into that business the highest type of man, and finally to encourage the co-operation of the investor, on whose shoulders rests some of the responsibility for the failure of investment banking properly to function.

MOBILIZING THE FUNDS FOR INDUSTRY

It becomes necessary now to investigate the manner in which the economic duties of investment banking are fulfilled. In brief, it may be said that it mobilizes the funds for industry rather too well, and at the expense of looking after the full needs of the investor. The financing of industry is to-day largely a merchandising proposition. The banker buys an issue of securities at the best price he can and resells it at a profit. In many respects it is like any other merchandising business and involves the risks of changing market conditions, and may entail a loss rather than a profit. All this is pure statement of fact, somewhat obvious, and apparently perfectly harmless.

But competition has grown noticeably in recent years, especially because of the formation of many firms composed of men who are brilliant salesmen but who lack financial responsibility. Since in many cases they have not the capital with which to carry securities they are forced to resort to their selling ability so as not to be forced to sacrifice in the open market the bonds or shares they cannot place with their clients. This situation has tended to increase competition and to put it on the plane of salesmanship rather than of service and judgment. It has been a gradual growth which has carried along many older houses which have

tried to resist. It is not suitable to present-day conditions under which investing has become so complicated as to call for a professional service rather than salesmanship.

This competition in the business and the necessity of supporting large sales forces has reached a point where the demand for new issues on the part of under writing houses has become so great that, except during unusual depressions when securities are obtainable for almost any price offered, bankers are bidding against each other for the opportunity to buy and resell bond and stock issues. This carries the prices paid for these new securities to a point where they must be offered to the public at prices which are very often relatively high compared to the general market level, and especially high for issues which are obviously unseasoned.

In fact, it has often happened in the case of issues of which there are already some outstanding, that the bid made to the issuing organization for the new securities has been so high that it has been necessary artificially to raise the price of those already outstanding to a point where it will be possible to sell the new ones and make a profit over expenses. In the Summer of 1922, just before the bull bond market then in progress came to an end, a certain prominent corporation requested bids on an issue of bonds it wished to sell. The banking house which secured the business made a bid (possibly as the result of an error) which was not far from the price at which previously issued bonds of the same mortgage were then selling on the

New York Stock Exchange. Naturally, it would not have been possible to retail the new bonds at that price and make enough money to cover advertising and selling expenses, not to mention ordinary overhead. So the bankers put in sufficient buying orders on the "Exchange" to put the price of the old bonds up some two points and then held the price there while they tried to sell both new and old bonds. Unfortunately for the firm involved, not only did the general bond market go against it, but the bonds were of the savings bank variety and, therefore, had to be sold to good judges of general market conditions and of bond values. Although the underwriting was unsuccessful, and perhaps for that reason as much as for any other stands out, the incident illustrates a method forced upon houses by the extreme competition and shows how the interests of the investor are inevitably side-tracked. Actually, the open market had probably fully appraised the value of the bond, and should the scheme have succeeded, as it so often does, the bonds would later have returned to their proper level, and the net result would have been that the investor had paid the cost of the distribution and the underwriters' profits instead of the issuing corporation doing so.

The same result obtains with new securities which have no previous issues on the market by which the general public, without more information than they usually get, can make a comparative judgment of values. Competition here is perhaps even freer because no price has been previously established and the

banker finds it easier to let his judgment as to value be swayed by his knowledge of his ability to sell. There is naturally a limit to what can be done along this line, but the point is again that the ability to sell is often of greater force in the determination of the price of new securities than is an actual measure of value in the light of comparative market conditions, and it is the investor who pays. Such methods are very pretty from the point of view of the companies issuing the securities, but hardly fair to the buyer.

Following further into present methods, we find that, having purchased an issue of bonds or stocks, especially if the issue be a large one, the banking house enlists with it some partners who share the risks and profits of the undertaking. A price is set upon the security—above the price to be paid, of course, and as much above as it is believed can be obtained—and a force of salesmen are set to work to sell it. In line with current custom, these salesmen are usually given commissions for their work. The goods are pushed and sold to those investors and banks which have money available for investment and which the salesmen can persuade to buy. The outstanding feature of the situation seems to be this: The interest of the banking firm is so absolutely and entirely to sell *this particular security*, and the interest of the salesman is so governed by his commission, that the actual needs and welfare of the investor, no matter how much they may be honestly held at heart, and no matter how good the intentions, are unavoidably overlooked except in

the rarest instances. This is perhaps a broad statement, but, nevertheless, it is a fact that the investors' side of the question is given but passing thought in far too many cases. In fact, the question as to whether an issue will be underwritten and the price to be asked very often depend more upon a forecast of the ability to sell securities than upon a mature judgment of its actual value and a forecast of its future prospects.

This matter of selling ability has become so important a factor in the investment banker's business that many houses are having classes in salesmanship. Men are taught the art of approach, the manner in which they should create interest and confidence, and finally how "to close." After going through some of the courses being given, a man should be able to make a living selling anything from automobiles to washtubs. As part of the selling course, they are taught that it is quite necessary to have a complete knowledge of their "product." Consequently, some of these men learn almost by heart the circulars issued describing the securities for sale, and the more intelligent finally get a pretty fair idea of comparative security values. There are others, however, whose savoir faire and poise are such that they sell securities on their personalities and make no pretense whatever of knowing what they are worth. While this may be a somewhat exaggerated picture, it is a regrettable fact that more stress is laid by some houses upon the art of selling than upon the knowledge and study necessary to a sound judgment of securities.

Now this competitive bidding and consequent requirement of selling facilities leads to certain faults other than that of excessive prices. One of the most apparent of these is that the salesmen too often attempt to persuade the investor to take securities which are not suitable to his needs and circumstances and which he ought not to have. Anyone who will dispute this statement need only glance over the investment lists of a few ordinary country banks. Here are organizations responsible for the money of their depositors and stockholders and supposedly prepared to supply the needs of their communities for liquid capital. Yet rather more often than is necessary a good portion of the funds are tied up in securities of very doubtful marketability and often, too, having a wide spread between the bid and asked prices. One would ordinarily assume that the country banker would know what he ought to hold, yet the fact that he so often holds what cannot be considered as a proper bank investment must prove not only that the average investor's knowledge of securities is very small, but that the selling methods of bondmen are successful. But if investment bankers can and will sell to banks bonds which are unsuitable bank investments, what chance has the ordinary investor?

Perhaps the greatest and most serious fault of this dependence upon selling ability is that it fosters the improper issue of securities. Among other things, the search for profits with which to support large selling organizations leads to much financing which should

never be done. Sometimes in the press of competition essential facts about the issuing concern are belittled or overlooked, not intentionally but irresistibly, because of the prospect of a profitable turnover made possible by a well-organized sales force. Again, because some one wants to keep voting control or for other reasons, bond issues or preferred stocks are put out by companies which, because of the inherent risk of the business, should be financed only by common stocks. By this investors are persuaded to buy bonds or preferred stock and to take the position of lenders of money to concerns whose business is so uncertain that the fixed interest-bearing security holder cannot have the prospect of profits proportioned to the risk taken. Investment houses usually know these facts, but are too often forced to overlook them and to stress the element of security unduly. If the competition were not so keen, because of the necessity of feeding sales forces, the banker rather than the company would be able to dictate the means by which the financing should be done.

It is sometimes the case that financing is arranged for companies in need of money, which concerns would better serve the community if they were sold to and became a part of larger units. By this is meant that, although there is nothing inherently wrong in financing any worthy enterprise, there are undoubtedly instances where funds are furnished small plants, public utilities or industrials, whose very size makes them uneconomical to run and risky background for securities.

Such plants could often better and more cheaply serve as parts of larger organizations and the investors' funds could certainly be placed elsewhere with greater security and larger profit.

Still other faults arise from the present organization of the investment business. One of these is the ability of a house to sell the securities of companies in which it is itself vitally interested. It is in such cases, when the companies are perhaps in difficulties, that the dependence upon selling ability becomes most evidently a breach of faith, and sometimes worse than that.

Two examples of the faults that lie in the present situation may throw a clearer light upon the subject. They are not in any way comparable to each other, but each illustrates in its way the dependence upon selling forces. In one case the stock of a new industrial was offered. One of the underwriters, by way of selling argument, related that the president of the new concern had raised his original capital by bootlegging. It is a far cry from bootlegging to handling the funds of honest investors, and it is easy to see to what school this banker belonged.

The other case is more common and more to the point. A certain entity desires to borrow on an extensive scale and offers an issue of bonds for public bidding. One prominent banking house, evidently desiring to identify itself permanently with the financial affairs of this borrower, makes certain of obtaining that particular bond issue by bidding not just higher than

anyone else, but very much higher. Now some of these banking firms do not make a practice of dealing directly with the investor, but often have very desirable bond issues and it is nothing less than disastrous to the ordinary dealer in the present system to fail to be invited to participate in the offerings of such houses. The bankers proceed in their regular way to offer participations to dealers, every one of whom knows that the price is too high, but few of whom, if any, care to refuse to participate for fear of being denied future opportunities. This is perfectly *all right so far as the originating house is concerned, for it is not dealing with the final consumer* but with those experienced in securities who go into the business with open eyes. But many of the dealers are without the financial strength necessary to carry their share and are forced to pass their load on to their clients. Many houses do thoroughly appreciate that they are simply paying for future opportunities and place their share of the offering in their strong boxes and do not attempt to offer the bonds to investors until market conditions justify such action. But so many of those as do resell any of their proportion of the issue merely make their customers pay for their future business. After the syndicate has been kept open for a very long time, a proceeding which does not seem called for and will be discussed later, the bonds finally have a free market and seek a lower and proper level.

One other feature seems worthy of consideration. Sometimes underwritings are more successful than was

at first anticipated. As orders come in and this seems to be the case, the books are suddenly declared closed, the issue announced as sold, and allotments cut down. The success of the offering has led to a belief that its price may go up, so the underwriters in this way try to save for themselves a large block which they hope to sell at a better price. The result is that quite often the issue, instead of being widely distributed, will be closely held by a small number, and the future market for that particular security is unfavorably affected. Not only the original purchasers, but those who buy in the belief that the issue was popular, ultimately suffer.

Altogether there are many evils in the present methods of financing industry, and it would be possible to extend the list of unsuitable types of financing to greater length. Investment banking does succeed in mobilizing capital, but there can be no doubt that it more often than seems necessary gathers together money for very questionable enterprises and uses types of securities not fitting to the particular situation. The point is that the investor must always be on his guard when, as a matter of fact, he should be able to put the same confidence in his investment adviser as he does in his doctor or lawyer.

While the above adopts a critical attitude of the present system of distributing securities, it is desirable to explain that while it makes possible the resort to questionable practices, it is not intended to deny the fact that there are many very high-grade men in "Wall

Street," men who never stoop to these practices and who criticize them severely. Like any large community, "Wall Street" contains men of all types, and on the whole honesty and fair dealing distinctly predominate. But there are many who could not exist in the "Street" if the system which now prevails did not foster and encourage the selling of securities rather than the competition of service.

The fault lies in the system by which securities are distributed and in the competition which has grown up under it, and partly in the attitude of the investor himself. Where there is so large an element of the personal equation (and character will always be the determining factor), it is quite impossible to eliminate all the evils, but there are some suggestions made in the following pages which it is believed might lessen the evils or render them less severe. It is to be hoped that the issue and distribution of securities can be put on a firmer foundation of judgment and value and that dependence on selling ability will become less necessary if not entirely avoidable.

Before proceeding to a possible solution of the problem, it is worth while to review in some detail the type of professional service which can be given to the investor, not only for the purpose of demonstrating its feasibility, but in order that the solution may take cognizance of the desirability of giving a professional service to the buyers of securities.

THE CARE OF INVESTED FUNDS

Mention has been made of the fact that the tremendous flood of securities which has come with the development of the corporate form of doing business is gradually tending to place an additional duty upon the investment banker and broker. This is the care of the investor's funds, not only at the time when the original investment is made, but thereafter. "Wall Street" is noted for giving advice as to what to buy, but rarely as to when and what to sell. And yet the care of securities after purchase is perhaps more difficult and more important than their original acquisition, for the reason that conditions change so rapidly and unexpectedly and the effects are sometimes so disastrous that the values of securities are materially changed because the risk has been greatly increased. It cannot be stated too strongly that the saved-up capital of the nation is most precious, it must be directed into channels where it will do the most good and it must be made to yield a fair return; afterward, it must be protected and preserved, it must be made to grow; and, if possible, its purchasing power should be maintained. The care of capital funds is a trusteeship, fundamental and underlying their mobilization into large amounts for industry.

The proper supervising of money available for in-

vestment calls for hard work, much study, excellent judgment and keen foresight. The work involved is much greater than any person engaged in other pursuits can possibly give to it and obtain proper results, and much greater than is usually undertaken by those whose dependence rests heavily upon selling ability. It requires a broad vision of general conditions, something ordinarily denied the ordinary investor who is so close to his own business that his judgment as to general conditions is apt to be warped. This is well illustrated by the fact, not thoroughly appreciated, that the worst judges of a company's securities are usually the so-called "insiders"; they are more apt to be sellers at the bottom and buyers at the top than any one else. And the reason is plain enough. When they themselves are enjoying good business, and profits are large, they see through a bright glass, but when business is bad, to them everything is blue. The banker, however, has a bird's-eye view of general business and can see the different industries in relation to each other—he sees the future more than the present. The banker can also look at comparative values and better determine the position a security deserves in its relation to others. The insider can give information, but even he needs the facts interpreted in the light of general business and security market conditions. Every man needs the matured judgment of a specialist in securities just as he needs a lawyer for law or an engineer to solve an engineering problem. His business may be booming, and to him there is no

reason why the stock of his company should not double in value, but if underlying conditions are such that the trend of security values is down, his stock will go with the rest. More than a few fortunes have been lost because this fact has not been recognized.

The plane which the proper investing of money has reached was well expressed by Prof. Arthur Stone Dewing¹ when he said:

"The general theory of business profits is applicable to investment; and further the investment of funds is a real business, subject to the rewards of true business foresight and the losses incident to attempts on the part of the poor business manager to invest funds. This is not self-evident. The school teacher, clergyman, lawyer, dry goods merchant, and shoe manufacturer know enough about their own respective businesses to feel assured that the ordinary uninitiated could not succeed without long and specialized training. Yet these same men stand ready to embark on one of the most intricate of businesses—that of investment—requiring perhaps the most extensive and far-reaching specialized knowledge of any profession or business. To compare intelligently, and with a degree of insight which makes the comparison something more than a guess, the credit obligations of Sao Paulo and the mortgage bonds of the Chicago and Northwestern Railroad, the debentures of the Detroit

¹ "The Role of Economic Profits in the Return on Investments," Harvard Business Review, July, 1923, Vol. 1, No. 4, p. 451.

Edison Company and the common stock of the General Electric Company requires acumen and a breadth of knowledge compared with which the ordinary professional and business judgments are child's play. And yet it is just such specialized knowledge and acumen which constitutes the business of investment, a business which many, without training or aptitude, feel qualified to embark upon with their own savings and those of their relatives and friends."

As he brings out so plainly, the selection of a medium for investment, and the watching of it after purchase, can be made only after the consideration of a large number of factors, all of which should be carefully investigated and fully weighed before an issue is underwritten or any other definite recommendations are made for the purchase and sale of stocks and bonds. The work required is primarily the digging into fundamentals in order to ascertain present and probable future values (especially the latter), and to gauge as accurately as possible whether the risk involved is greater or less than the return to be expected. From the economic point of view, funds should be placed in the spot where they will do the most good, and on the whole it will be found that this is the place where the return is greatest in proportion to the risk. Naturally, where forecasts of the future must be made, there is large room for error, and one overlooked fact is often important enough to change the whole forecast. It is impossible to be invariably right, and any one person is sure to be wrong very often. This is

perhaps one of the reasons why there is so much carelessness in appraising securities; that is, that one can be wrong so often it is hardly worth while to make every effort to be right. But this does not excuse the failure of those who deal in securities to leave no stone unturned in order to be as right as often as possible, and wrong as rarely as possible.

It has been said that investing is a mere matter of common sense, and so it is. But it is common sense based upon a knowledge of what constitutes security values, and such knowledge can only be acquired by one who is constantly studying securities and conditions bearing upon their future. Investing has been called an art, and perhaps that is as good a name as any other. Mr. Morrell W. Gaines in his book, "The Art of Investment,"¹ brings out very clearly the many factors which the investor should watch in order to acquire the art of making his funds grow. It is maintained, however, that it is only the very exceptional investor who can possibly have the training, knowledge, or time required to reduce the hazards of investing to a minimum and to put it on a businesslike basis.

Perhaps it is not realized yet how intricate a process is the selection of a proper investment. It will be well, therefore, to outline, as briefly as possible, some of the questions involved, and later, in more detail, the methods which will probably have to be pursued in finding the answers. Investing is gradually getting

¹ Ronald Press, New York, 1922.

upon a new plane and drawing away from the haphazard. It is becoming recognized that methods may be employed which tend to reduce the risk and to put the handling of capital funds upon a more scientific and businesslike foundation. These methods make possible what has been termed a strictly business profit, that is, a return over and above that which consists of "pure interest" (interest without risk) plus a further amount proportioned to the risk. The growth of the more up-to-date manner of handling invested funds has given rise to such services as Moody, Poor, Babson, Brookmire, and others. These rest their strength partly upon the fact that they have no securities for sale. The purpose of these pages is (on the other hand) to attempt to show how the banker and broker can, by urging a change in our system of distributing stocks and bonds and by urging the forced publicity of full information, succeed in putting himself in a position to give even sounder professional advice and service. Even should these aims be not attained, the success which has marked those who are adopting up-to-date methods and a definite procedure in managing security holdings will, through the influence of competition, force all others to follow substantially in their footsteps. The following outlines roughly the ideas which are developing.

The first problem is quite naturally to see that the investment is secure. To some this means merely a matter of property value and earning power, but the new practice calls for much more. It requires a thor-

ough study of general conditions, of the conditions within the particular industry in question, and of the situation within the company itself, to be sure that there is nothing which would lead to the belief that, the unexpected excepted, the principal will remain intact and an income be regularly received or reasonably anticipated. This is, of course, done in a vague way at the present time, but in the future it is probable that much more detailed work will be done upon these investigations. But this is only the beginning. Constant study along the same lines must be continued so that every effort will be made to forestall the unexpected and to meet changed conditions.

Under the heading of general conditions alone we have to-day a number of questions of extreme importance. For instance, the United States holds nearly fifty per cent of the world's gold. What will be its influence on commodity prices? How will it affect foreign trade and those dependent on exports for their prosperity? What may be its influence on future tariff laws? Here is a fundamental condition which will probably affect in some manner all our securities, some favorably and others unfavorably, and some answer to these questions must be sought. In the first place, the gold we have is well beyond our needs as a reserve for our currency; this is indicated by the large amount of yellowback bills now in circulation. There has never been a time when this country has not made use of its available credit resources when business was favorable. Just now (October, 1923)

there is great caution due to the memories of 1920 and 1921, but will not our credit facilities be ultimately utilized as they have been in the past? Since they are more than is needed by the productive capacity of the country, if our credit resources are so completely utilized, is anything going to prevent another period of inflation? Is there any method by which inflation can be prevented? Is not inflation the economic method by which the surplus gold supply will be redistributed to the rest of the world and a better equilibrium obtained? In other words, will our gold go out of the country in any other way than in payment for goods attracted by high prices in this country or in payment for securities attracted by low money rates? This is one of the really fundamental questions of the day so far as securities are concerned, for if there is to be inflation it is quite inevitable that fixed income bearing securities should go down, and stocks of companies which will profit by rising prices should go up.

Also, if high prices will attract goods to this country, it would be well to try to anticipate the industries which will most likely be unfavorably affected, and to sell the securities of companies in such industries.

Fundamental as this problem is, it is possible to hazard the guess that not one investor in a hundred and few investment houses have made a definite attempt to get an answer, and to govern their advice to the investor accordingly.

There are other problems of the same general

nature. It is generally believed that sooner or later a general decline of commodity prices will set in. It is probably true that in time this will be the case. Under such circumstances it always takes more careful management to earn money and it grows harder to pay debts, for it requires more units of a product to produce a dollar of profit. How many people, recognizing this, have laid their plans to eliminate from their lists the bonds of small industrials due ten or fifteen years hence? There is the problem of labor and its apparently increasing cost. Must we have a pitched battle with labor to get wages down, or will labor-saving devices and increased efficiency bring the lower cost per unit of output? Under general conditions we have also a survey of the banking situation, the productivity of industry, the supply of commodities and of labor, the transportation situation, prices, etc.

A study of these factors is part of the study of the business cycle. Since there is growing a tendency toward investing money in accordance with the cyclical movement of business, it will be pertinent to discuss this subject in greater detail in another chapter.

With a clear picture of general conditions it is then necessary to study separate industries. For instance, those who, shortly after the depression of 1921, delved deep, easily foretold the prosperity of the sugar producers in 1923. It was plain at that time that, due to the low prices then prevailing, cane plantings in Cuba were small and the beet sugar producers in this

country were curtailing. It was then very evident that a short crop was going to come and that those companies which were strong enough to survive the depression would ultimately make large profits. At the same time it was clearly evident that the fertilizer companies were in for a long struggle; the burden put upon this industry by the necessity of carrying the farmer was one which would unquestionably prevent the resumption of dividends for a long period. Just now, before buying copper stocks, it seems important to determine the influence of the low cost South American mines on the domestic producers. In other words, even though general conditions point to a favorable investment period, not all industries will necessarily be attractive channels for investment funds.

Coming now to the question of the specific corporation whose securities are to be considered, after having come to a conclusion as to whether general conditions and those within an industry support the belief that money can well be invested, it is, in the case of a new issue, necessary to discover whether that particular corporation is sound enough to assure the safety of the principal and of the income of funds placed therein. This is axiomatic. But again, this is not enough. There should be made as careful a study as possible of the available data about other companies in the same industry so that there may be a foundation for a judgment as to comparative values. When it is a question of investing in seasoned issues such a

comparative study is required before there can be selected that issue which seems to give the best prospects in proportion to the risk to be taken, and such a study is even more essential in order to minimize the risks of stock investments and speculation.

To assist in making an investigation of the relative standing of various companies within an industry, there is available a mass of statistical information from which those who have the training and knowledge can obtain a great deal of value, but this should be supplemented by something more. Any one who goes thoroughly into all the figures offered will find much that he does not understand, and many questions will naturally arise. These ought to be answered, and they can only be answered by those thoroughly familiar with the corporation's affairs. In brief, some one in the company should be asked to answer the questions and to amplify the information. Unexplained figures can sometimes lead one far down the wrong path. A case comes to mind which illustrates this point. A prominent investment service compared two companies in the same industry. It will be convenient to designate these as "A" and "B." After reviewing the balance sheets of the two concerns, this service pointed out how little working capital was possessed by A compared to B and suggested that the stock of this company should, therefore, be sold and replaced by that of B, which, as evidenced by the figures, was in far better position to continue dividends than was A. Another person, however, in an

independent study noticed that A carried in its balance sheet, but not as part of its working capital, an item of some ten million "investments" without disclosing what these were. He proceeded to ask an official of the company what made up the item and was informed that it consisted of United States Government bonds. The company's liquid capital was, therefore, not only ample, but far exceeded that of B. He made a recommendation the reverse of that of the service and was rewarded by seeing A gradually draw far above B. It is evident that a careful study cannot stop with a single scanning of published figures, but it must be known what they mean. Usually company officials are willing to give the called-for help, but occasionally they are not. In the case of the latter, their securities should no longer be considered but placed upon the list of those about which insufficient information is obtainable on which to form a sound opinion as to their worth. There are too many other fish in the sea, and besides, under present-day conditions, it seems wise to know a few securities very well rather than to have a little knowledge of many.

So much for determining the choice of the securities themselves. The next problem is to select from a list so set up those which are suitable for the particular person whose money is involved. This calls for a consideration of many personal factors such as the size of his or her income so that full allowance may be made for taxes to be paid. The source of the income should be known for the same purpose and

for the purpose of determining whether a rising cost of living is likely to be compensated for by increased income from business, or should be allowed for in arranging the security list. The age of the investor is generally a determining factor in the choice of bonds and stocks. It is naturally important also to know what securities are already held so that proper diversification as to type, industry and geographical location can be obtained. On the whole, the financial adviser who intends to do his job up brown, and to leave no stone unturned in giving a truly professional service, will need the full co-operation of the investor and should have all the information necessary to the forming of a judgment as to what securities it is proper for the buyer to have.

There are many who will object to giving such personal information to their bankers or brokers. This is because the atmosphere of professional relationship is lacking. The investor should realize that such data is in many cases far less personal than that which he gives to his doctor or lawyer, and that it is just as safe in the banker's hands, if the banker or broker has been carefully chosen, as it is in the hands of any professional man.

Earlier in this discussion it was indicated that the selection of a medium for investment was only a beginning and that, over a period of time, the banker should use every effort to watch over the investments in order to maintain the capital intact, to try to make it grow, and, finally, to attempt to maintain its pur-

chasing power. This latter subject must be treated in the discussion of the relation between investment and the business cycle. Merely to maintain a principal fund, however, requires something more than a careful primary selection. There are those who have never bought anything but the most gilt edge bonds and have put them away and forgotten them. They have felt that they were most conservative and far from speculating, but recent years have proven the reverse; they were worse than speculating, for that means the use of foresight; they were gambling that conditions would not change.

One such man retired from business, put all his fortune in the highest-grade securities, turned these over to his bank for safe-keeping and the collection of his income, and devoted his time to philanthropy. Conditions changed; costs and prices began to rise; certain companies in splendid shape when he bought the securities were in the hands of receivers ten years later; the principal was severely reduced, and the purchasing power of the income left to him was cut in half. Had he watched his securities, or employed another to do so, he could have counted his savings in the hundreds of thousands, and it is probable that he could have, by judicious shifting of investments, largely compensated for the rising cost of living.

The question of selling securities in order to prevent a loss brings up a psychological problem. It is only too often that, in order to improve an investment list by shifting from one security to another, it is

found necessary to sell at a loss. A large percentage of investors hesitate to sell at a price lower than that paid even though they are trying to prevent a larger loss which is clearly indicated. It cannot be expressed too strongly that the price paid for a security has not the slightest bearing on whether it should be sold or not. That depends entirely upon the future outlook, and if by selling and reinvesting the money it can be made more secure, that is the thing to do regardless of the price to be obtained for the securities disposed of. It is unfortunately true also that bankers and brokers hesitate to advise taking losses in securities which they have previously recommended, for it is tantamount to the admission of an error. Investors should realize, however, that where there is so large an element of forecasting as there is inevitably in investing, it is impossible to be infallible. They should consequently be broad enough to encourage the best advice, and blame those only who quite evidently gave their original advice without sufficient care and study. In general, it may be said that the failure to take losses while they are still small is probably the greatest cause of the losses made in stocks and bonds.

It has been said that the only purpose of investment is to "buy an income." In turn, it may be asked, an income of what, dollars or what dollars will buy? The true art of investment includes something more than the mere buying of bonds and stocks and then forgetting them, and it includes something more than

security of principal and income. Stocks and bonds do not stay long on a level. Therefore, if not bought with a reasonable expectation of appreciation, there is probably more than an even chance of depreciation. The soundest recommendation to an investor will, as a consequence, be found to have taken this into consideration. There will, of course, always be a solid background of bonds which will be under constant supervision and shifted from one issue to another as conditions warrant. A well-balanced list will also include a percentage of sound dividend paying common stocks, carefully selected and bought only at the right time. Many will look upon the purchase of common stocks at any time as rank lack of conservatism, but with proper investigation, constant watching, and their purchase at a definite point in the industrial cycle, common stock investments are far less unconservative than buying bonds and then forgetting them. In fact, handled in such a manner the risk is not only small, but they can be made a great source of profit. Incidentally, it is equally imperative that at another and equally right time such stocks must be sold.

The varying trend of money rates makes it possible also, by shifting on appropriate occasions from long-time to short-time bonds, and vice versa, to maintain that part of the principal invested in bonds and to assist in its growth. The ability to use short-time bonds in preserving the principal arises from the fact that as a bond nears its maturity date, changes in money rates cause less fluctuation in its price. In a

5 per cent bond market, a 5 per cent bond due fifty years hence will sell at par, as will also a 5 per cent bond due in two years. Should a 6 per cent bond range succeed, the bond with a fifty years maturity would sell at about 84.20 and the two year bond at 98.14, a loss of $15\frac{3}{4}$ points in one case against only $1\frac{7}{8}$ points in the other. In a 7 per cent money market the respective prices would be 72.34 and 96.33, showing even more clearly the saving in principal which can be made through judicious shifting from long-time to short-time bonds when rising money rates are clearly evident. The reverse trend of money rates quite naturally gives an equal opportunity for profit.

All of these things require much time, effort, study, training, and patience on the part of both the banker or broker and the investor, and it is certainly not the role of the lazy person. It seems evident that although forecasting, with all its chances of error, is necessary, any deviation from the course outlined, or any attempt to short-cut, make investing by that amount haphazard.

It will be said that this type of service is given by the so-called investment "service," and much better than the banker can do it. Such an argument is based largely upon the fact that the "services" have no securities for sale and are consequently unprejudiced. But as bankers and brokers equip themselves to give this service, it will be found that they can be as reasonably unprejudiced as any "service" and have great advantages the latter do not possess. In the first

place, these organizations do not have the intimate, personal, rather professional, relations which the banker or broker can have with his client. Secondly, these bodies do not investigate the individual companies as thoroughly as a banker can and should do, and in his underwritings he can get much information not available to the "services." Further, the banker can give an additional service based upon the knowledge of market conditions surrounding particular securities. His aim should be to know a moderately diversified list of securities very well, rather than to have a smattering of knowledge about many. Finally, the "services" are available to the banker and he can add his own to theirs.

It should be clearly evident that only those with a high degree of knowledge and training can do justice to the savings of the nation and that the care of invested funds is an intricate matter requiring the same deep study of general conditions, of industries, and of companies that is necessary before an underwriting can properly be undertaken. And this study must be continuous so that untoward and unexpected events may as far as possible be provided against and the principal of a fund maintained and enlarged. There is, in addition, reason to believe that a thorough supervision of capital funds will be able to give the income a more stable purchasing power.

The foregoing will indicate that perhaps there is, after all, something new in the methods of choosing investments and watching over them. There is gradu-

ally arising a new science, that of the interpretation of business statistics in the light of economic knowledge. Or rather, it might be put, there is emerging from the use of business statistics a more scientific political economy. And with it is coming its application to the field of securities.

THE ANALYSIS OF GENERAL CONDITIONS

The background of all investing is a thorough knowledge of the basic underlying conditions, those which are so powerful in their effects that they will influence the whole trend of the business cycle, that is, they may either retard the development of the cycle or hasten it. To get at the root of these questions requires a firm grounding in economics, and a thorough understanding of the cyclical movement of business.

It seems little short of extraordinary how little economic knowledge the general run of business and professional men have. Everything that is bought or sold and nearly everything that an individual does is governed in some manner by economic laws, and yet very few have any idea that this is the case or know how current conditions will affect them. Most men have some hazy idea of the "law of supply and demand," of "over-production," and many have heard that there is a "business cycle" but just what these things are, and what relation they bear to business or securities, is only beginning to be appreciated. In general, the economist is looked upon as academic and, on the whole, impractical, and his work is spoken of more or less slightly. Fortunately, there is on the way a greater appreciation of his worth and prac-

tical value to the business world, and in many places there is appearing an increasing desire for economic knowledge. It is noticeable that many banks now have on their staffs, and in some cases in the position of high executive responsibility, a man trained in the study of economics. It is noticeable, too, that many business executives are giving time to its study and in some cases are making good use of the economist. And it is an excellent thing, for as economic knowledge spreads, there will come a better realization of exactly where each stands in relation to the other parts of the industrial machine, and there will come a better understanding of the problems of others. It is not too much to say that as economic knowledge becomes more universal it will bring greater stabilization to industry and a leveling off of the peaks and valleys of booms and depressions.

Perhaps the outstanding difficulty arising from ignorance of economics is the passing of legislation which interferes with the free action of economic law or sets into action results which only the economist can foresee. As a general proposition it can be said to be almost axiomatic, that whenever there is put upon the statute books a law which is contrary to sound economics, the result is worse than the situation which our high-minded legislators were trying to mend. Not only do the people as a whole suffer as a consequence, but the very ones whom the law was designed to help suffer with the rest. It is probable that many volumes could be written giving in detail

the laws which have had such results. There is one of the kind proposed now, the soldiers' bonus. Should it pass there will probably follow a considerable upturn in business, depending, of course, upon the manner of payment, but the probabilities are that the man who receives the bonus will pay for it handsomely in higher prices, higher taxes, and ultimately in loss of work. If our legislators were endowed with some knowledge of economics, and were prepared to use it, the country might be spared what may turn out to be a very dangerous thing. They might well study Emerson, whose advice was that,

"Wealth brings its own checks and balances. The basis of political economy is non-interference. The only safe rule is found in the self-adjusting meter of demand and supply. Do not legislate. Meddle, and you snap the sinews with your sumptuary laws. Give no bounties; make equal laws; secure life and property, and you need not give alms. Open the doors of opportunity to talent and virtue, and they will do themselves justice, and property will not be in bad hands."

Illustrative of the influence of a vague knowledge of economics upon business and security judgments, there can be listed a number of opinions which are widely held and which have been based upon a misconception of the true significance of certain factors in the industrial situation. During the summer of 1923 the United States saw, for the first time in years, an excess of imports over exports. This was at once

interpreted as a very unfavorable turn of affairs. Little notice was given to the fact that the excess of imports was due to a growth in the volume of incoming goods rather than to a substantial falling off of exports. Nor was there general realization of the fact that the large importations were in themselves a good measure of our very prosperity. Exports may tend to help our prosperity, but they are a better measure of the buying power of others than of our own, and in like manner imports are a measure of our ability to buy and of our prosperity. It is worth noting, too, that the larger imports came mainly from Asia and South America and consisted of commodities which we do not produce or produce only in insufficient quantities and which, therefore, do not compete with our goods. The higher standard of living in the United States and its enormous buying power was reflected in enormous imports of silks, tea, coffee, sugar, etc. The purchase of these goods has enriched other countries and has enabled them to buy either here or in Europe, thus assisting that continent back on its feet. The United States will be more prosperous with a large volume of trade—both exports and imports—than without it, and since she has the largest buying power at the present time she holds the means to restart the world economic machine. That she should be importing large quantities of things she does not produce does not, therefore, seem to have any very unfavorable significance, but rather the reverse.

Another fallacy of the day is the widely held atti-

tude toward labor. It is said that wages are so high that it is impossible to do business profitably until wages come down. Some go so far as to predict a pitched battle with labor. The truth of the matter is that we have limited the growth of our supply of labor by severe restrictions on immigration. Labor may not be a commodity, but the price of labor is nevertheless largely governed by the supply and demand for its services. Having limited the supply, it is natural that its price should go up. In combating the effects of the situation thus brought about, the ordinary man thinks only in terms of price rather than cost. The way to meet the situation, and the way in which it will undoubtedly be met, is to reduce the labor cost. This will be done by improved machinery and greater efficiency, and as labor produces more it will, as it has always in the past, get a larger share of the production. What is possible along these lines can be illustrated by two examples. There is a factory near New York which in 1920 was turning out 12,000 units of its product in a given length of time with, roughly, 750 workers. The factory is now making 17,000 units with 525 men. The present labor is receiving practically the same wages as those paid in 1920, but it is hardly possible to say that the labor cost is as high. The New York, New Haven and Hartford Railroad has published some figures of the same character.¹ In 1916, the road required 107,000,000 man-hours to handle its traffic and, in 1917, 120,-

¹ Commercial & Financial Chronicle, Vol. 117, p. 1885 (Oct. 27, 1923).

000,000 man-hours. In 1922, the road carried more passengers than in either of the two earlier years, carried more freight measured in revenue ton-miles than in 1916 and almost as much as in 1917 with 89,000,000 man-hours. There seems little likelihood that there must be a pitched battle with labor in order to get labor *costs* down. The cost will be reduced but not the price, that is, wages.

The farmer's situation is somewhat similarly judged. Recently a New York newspaper had two columns side by side. The heading of one read in substance, "Farmers' Purchasing Power Hurts Business"; the other, "Sales of Mail-Order Houses the Greatest in History." As the farmer is the main customer of the mail-order houses, both could hardly be accurate; and yet it is generally accepted that the farmer is too poor to buy. Let it be granted that the prices for farm products have been low and that this large part of our purchasing power is impaired. Is that any reason why he shall call for a reduction in the prices he must pay for the services he receives, for instance in the price of transportation for carrying his products to market? Is not the answer to the farmers' problem the same as that of the manufacturer: reduce the costs by improved methods and increased efficiency of production and marketing rather than by forcing others to give of their time and capital for an unfair return?

Europe is another subject about which there is much discussion and unsound opinion. It is said, for example, that since the mark has gone to virtually noth-

ing, Germany has no buying power and that it will be years before she can recuperate economically; Germany is obviously going the way of Russia, is the current thought. Such a belief rests upon the failure to differentiate between the economic situation and the fiscal. Money is a medium of exchange which, to be an effective instrument for this purpose, must have a stable value. The constant adding to the volume of currency and the inability to exchange it for gold has reduced the value of the mark as a medium of exchange. This has, of course, greatly complicated the interchange of goods within the country and between the citizens of Germany and those of other nations. Consequently, it has had some effect upon its present economic situation. But the purchasing power of a country lies in its ability to produce, and this is where Germany differs from Russia. In the latter country, by the introduction of unsound economic doctrines which curbed initiative, the productive capacity has been severely damaged, but in Germany, the productive capacity has in the last two years, if anything, been largely increased. When the smoke clears away it will probably be found that that country, regardless of the currency situation, is economically strong. It is not unlikely that Europe as a whole can be compared economically to the United States in the early part of 1922. The productive power is there, liquidation is complete, and there has been a long period of underproduction. The men who direct business affairs, however, are not prepared to assume the risk of com-

mencing operations while the political uncertainty continues. When confidence is restored, the economic progress of Europe will probably be amazing.

Over-production is a word which is currently much misused and gives rise to false economic notions. It can be stated that there can be no such thing as general over-production, for the desires and needs of the people as a whole can never be filled. There can, however, be ill-balanced production; that is, the production of one type of goods can be larger than can be absorbed by the people who are not producing enough of other things to pay for it. Over-production is, therefore, a situation which can arise in particular industries but not for industry as a whole, and can quite properly be called under-production of other things rather than over-production of the article in question.

These are some of the problems which are more or less widely discussed. There are others, however, of fundamental importance which at this time are heard of less, but which will have a large bearing upon the future of business and of security values. It has been pointed out how important is the fact that the United States holds nearly fifty per cent of the world's gold. This amount is largely in excess of that needed to give us a reserve to support the credit resources necessary for our productive capacity. Any use of it beyond that limit will almost surely lead to speculation and rising prices, ordinarily called "inflation." So far, the situation has been handled admirably, not only by the Federal Reserve Banks, but by business men as a

whole. As we draw further away from 1921, will business caution become less? Will politics interfere with the orderly working of the Federal Reserve system? These are questions which only the future can answer, but anyone who holds securities should keep on constant watch to see what the trend of events will be. It is known that, so far, this country has never failed to use its credit resources in full when the time was favorable. It is fairly sure, too, that the only way the gold can be reduced to a more normal amount will be by the purchase of goods attracted to this country by an inflated price level. The exception would be through the purchase of foreign securities which the American investor has not yet been educated to buy. It is possible that careful handling will keep the gold from use until such an education is completed. In the meantime, the sharpwitted investor will be prepared to rearrange his holdings to fit the event.

Another underlying factor of importance is that the United States is to-day a creditor nation. This means that we are owed large sums of money for the payment of which we must be prepared to accept gold, securities, goods, or services. Some look upon it as a sure sign that the country will be flooded with goods in competition with our own. The tariff, which is elastic, will probably be an effective barrier to such competitive importations. But we probably will receive large payments, via the tropics and Asia, in goods which we do not produce. It may have some effect upon our exports, but this is a growing nation of

110,000,000 people who are requiring always a larger share of our own production. In fact, our imports of food stuffs, sugar, bananas, tea, coffee, etc., have for some time been increasing and are probably now in excess of our exports of wheat, corn, meat, etc. Our export trade is probably not more than seven or eight per cent of the country's business turnover in any case. So, except for a certain few industries especially dependent upon exports and which, like copper, may have serious competitors, the fact that this is a creditor nation should not spell ruin to our prosperity.

Of wide importance, too, is the efficiency of the transportation system. Our productive capacity may be great and our purchasing power large, but if goods cannot be exchanged, business will suffer. It is consequently of importance to one who would keep close tabs on general conditions to constantly watch the efficiency of the railroad plant and anything which will affect it. Suppose railroad rates were to be reduced to a point where the operation of the carriers would prove unprofitable—and rates are not far from that point now—it would be quite natural to sell railroad securities. But if the roads are not going to build and are not going to have the inducement necessary to initiative and efficiency, the whole industrial system will suffer and industrial securities, too, might as well be sold.

So much for the general economic background. These questions are of more or less continuing importance—until settled one way or the other. There is

yet to consider the business cycle about which there is some general knowledge, but not enough to assist in its use in forming a judgment as to general conditions, the times to buy and sell, and the types of securities to hold during particular phases of the cycle. It may be said that the average man thinks of the business cycle as the alternation of booms and depressions in a rather regular period of time. To form a clearer idea of the phenomenon of the cycle, it is better to say that it consists of a fairly regular sequence of economic events which cause a depression to emerge into prosperity and a period of prosperity to develop into a depression, but the time between the two points is irregular and affected by many things.

There are many theories as to the cause of the cycle.¹ Beveridge ascribes the rise and fall in the volume of business to competition, to the attempt of many to fill at one time a limited demand, bringing over-production;² May, to increasing productivity without a corresponding rise in wages to maintain a sufficient purchasing power to use the output;³ Hobson, to over-saving which brings about over-expansion of industry and glutted markets;⁴ Aftalion, to the effect of general

¹ The summaries of business cycles referred to were taken from Mr. Wesley Claire Mitchell's "Business Cycles," (University of California Press, 1913), pages 5-18, in which will be found brief descriptions of these theories, except that of Mr. Henry L. Moore.

² W. H. Beveridge, "Unemployment," ed. 3 (London, 1912), Chap. IV.

³ R. E. May, "Das Grundgesetz des Wirtschaftskrisen" (Berlin, 1902).

⁴ "The Industrial System" (London, 1909).

over-production in reducing the social use-values of the whole mass of commodities offered for sale;⁵ Bounitian, to over-capitalization in times of prosperity;⁶ Spiethoff, to the ill-balanced production of industrial equipment and complementary goods;⁷ Hull, an American, to high construction costs;⁸ Lescures, to the variations in anticipated profits;⁹ Veblen, to the discrepancy between prospective profits and current capitalization;¹⁰ Sombart, to the uneven expansion in the production of organic goods, dependent on harvests, etc., and inorganic goods;¹¹ Fisher, to the tendency of money rates to lag behind changes in the price level;¹² Carver, to dissimilar fluctuations in the price of producers and consumers goods;¹³ and, more recently, Moore has attempted to demonstrate an eight-year cycle caused by non-economic causes, probably astronomical, and possibly traceable to the influence of Venus.¹⁴

⁵ A. Aftalion, "Essai d'une théorie des crises générales et périodiques" (Paris, 1909).

⁶ M. Bounitian, "Studien zur Theorie und Geschichte der Wirtschaftskrisen" (Munich, 1908).

⁷ Published in Schmoller's "Jahrbuch für Gesetzgebung."

⁸ George H. Hull, "Industrial Depressions" (New York, 1911).

⁹ Jean Lescure, "Des crises générales et périodiques de surproduction" (Paris, 1907).

¹⁰ T. B. Veblen, "Theory of Business Enterprise" (New York, 1904).

¹¹ W. Sombart, "Schriften des Vereins für socialpolitik."

¹² Irving Fisher, "The Purchasing Power of Money" (New York, 1911).

¹³ T. N. Carver, "A Suggestion for a Theory of Industrial Depressions," *Quarterly Journal of Economics* (May, 1903).

¹⁴ Henry Ludwell Moore, "Generating Economic Cycles" (New York, 1923).

Probably the most painstaking and most scientific investigations of these theories have been made by Prof. Wesley Claire Mitchell, now with the National Bureau of Economic Research, and by Prof. Warren Persons of the Harvard Economic Service. Professor Mitchell investigated the trend of many business factors in the United States, England, France and Germany from 1890 to 1913, and it is quite remarkable, and some proof of the soundness of his theories, that even during such an abnormal period as we have had since the war, the trend of economic events remained practically unchanged. To describe the business cycle in the clearest manner will be best accomplished by tracing the course of a typical swing from depression to depression.

During a period of bad business, consumption continues at a pace which, while less than during prosperity, is not so far reduced as is production. The cutting down of production has thrown many men out of work, the efficient only are retained and, jobs being scarce, they work harder. Shorter hours have added to labor's efficiency. The inefficient plants have been shut down. The prices of raw materials have fallen further than have the selling prices of finished goods. Spare time has given an opportunity to repair plants and put them in good shape. As consumption took the excess stocks of goods left after the boom, loans have been paid off and money has accumulated. Lower prices make it possible to do such business as is being done with a smaller use of credit, and money rates tend

downward. On the whole, it is found that costs have gone down much more than selling prices, and the range between the two is wide; the profit per unit of output is large. But the volume of production is not large enough to make total profits carry the overhead.

This condition may last for a long or a short period. In time, something happens to bring greater confidence. Perhaps builders have found money rates low enough to be attractive for long-time borrowing for building purposes. Possibly, as in 1921, this is accompanied by another event such as a short cotton crop, bringing a sudden turn up in the price of that staple, thereby restoring the purchasing power and confidence of the South. Somewhere some one begins to do a little more business and in turn begins to buy from others. Gradually this seeps through the economic structure until confidence is completely restored and business increases in activity. The volume of manufacture rises, but the costs still remain low. Overhead is being covered, however, and a profit is being made. More men are taken on, but these remain relatively efficient. Slowly and gradually the activity increases. Prices of raw materials rise, wages rise, and selling prices rise—more slowly. The higher prices as well as the greater activity adds to the needs for credit and interest rates rise. Later more men are taken on and these are the inefficient; men become less afraid of losing their jobs and the output per man becomes less. The inefficient plants are opened and men are worked overtime. Costs have risen greatly and much less than selling prices.

Although the profit per unit has now become small, the very heavy volume of production yields large total profits and everyone is cheerful. Money has come into increased use, especially to carry goods made for stock in the anticipation of selling on a rising market. Production becomes ill balanced. The bank reserves have been depleted and money has become not only costly but hard to get. Some loans are not renewed and goods are forced upon a satiated market in order to supply the funds for payment. Selling prices begin to decline and it is difficult to sell on a falling market. Business is found to be operating on a very low profit per unit and the moment the volume goes down profits begin to vanish. Then comes the period of liquidation where the buyer makes the market and the sellers compete for his patronage. Each industry reacts upon the others, employment decreases, purchasing power declines, each in turn impelling the other downward. This situation continues until consumption has taken up the slack where it exists and confidence has returned.

Such is the general outline. On the average the length of a cycle in the United States has been from three to four years, with major cycles approximately ten years apart. But it is the sequence of events which is important rather than the time, for wars, politics, good or bad crops, and other happenings of a fundamental nature may halt or hasten the development of the cycle. It is also possible that the now

strong centralized banking system in the United States may tend in normal times to lengthen our cycle.

The investor is, of course, interested in profits, for therein lies his surety of income, whether interest or dividends. But he is also decidedly interested in money rates, for these largely govern the selling price of invested capital. The interest rate is a reflection of the demand and supply of credit and influences the selling price of securities in two ways: First, the selling price of securities moves in the opposite direction to interest rates. This is more or less obvious and thoroughly appreciated, for in a five per cent money market a security paying five per cent will sell at par, but the same security paying the same dollar income in a six per cent money market must sell at a lower price to yield six per cent, and at a higher price should interest rates go, say, to four per cent. Secondly, there is the indirect manner by which interest rates affect the selling price of securities. When interest rates are low, it denotes a lack of demand for credit, and a plethora of funds with which to buy securities; and when interest rates are high, it indicates a heavy demand for credit and the lack of it for use in the security markets. It is of especial importance to follow the cyclical action of money rates and their influence on security prices.

It was pointed out that during a depression money accumulated and became a drug on the market. The banks cannot lend it to business for industry is busy paying off loans rather than borrowing, and the banks

are rather nervous about lending to industry in any case. The rates for money for short-time borrowing are low. To keep their available funds fully employed, the banks have only one recourse and that is to buy bonds. It is generally the case also that bond yields are higher than the rates for short-time loans, and this is quite naturally an added inducement for placing money in the bond market. Bonds consequently begin to rise. Incidentally, the prevailing pessimism causes the flow of the largest part of such money as is available for investment into the bond market and gives an added impetus to the rise. Even after confidence has returned, interest rates continue to fall, for the increasing activity of business has allowed the more completely tied up loans to be liquidated, and those that have no loans have cash in sufficient amounts to carry the added business being done. Interest rates continue to fall until the activity of industry and trade reaches the point where new borrowings exceed in amount the loans being paid. When this turn comes, not only does the tendency for money rates to harden appear, but the banks, having other outlets for their available funds, are no longer dependent upon the bond market. While there may be a continuing large demand for bonds from insurance companies and the general public, and quite likely some speculation tending to give momentum to the rise in bond market, the turn in interest rates, which is coincident with the end of bank buying, marks the top of the rise in bond prices. From this point on, this market is under the pressure

of rising interest rates caused by heavier credit demands due both to more active industry and higher prices. The banks have begun to sell bonds to provide the funds for commerce. Later the rising cost of money leads to the additional pressure of sales by corporations and individuals who would rather realize on securities than pay the going rate for money at their banks. In time such a movement may be culminated with the forced sale of securities in order to pay off bank indebtedness or to protect high cost inventories from forced sale.

So much for interest rates and bond prices. The rates for money have a more or less similar influence on the prices of stocks. At the bottom of a depression stock prices are low. After a period of some months of rising bond prices, and in the case of certain very high grade stocks almost coincident with the rise in bonds, there usually begins an upward movement of stocks. This movement is led by those stocks on which the dividends appear to be safe, in spite of a period of low or vanished profits. Money rates being low and money easy to borrow, it has become a profitable operation to buy stocks which are yielding anywhere from 6 to 10 per cent and to carry them on borrowed money with an outlay of interest of 4 per cent or less. The gradually returning confidence leads also to a reappraisal of the risk involved in such purchases and the premium over pure interest declines, adding further impetus to the rise in stock prices. The movement of stocks is given momentum at this point by

the purchases of those who have sold short and have overstayed their market. The primary rise in stocks seems, therefore, to be due first to low money rates reacting favorably on stocks with reasonably assured dividends, to gradually increasing confidence in the business outlook, and to the purchases of those who sold in the expectation of a further decline in stock values. With more thorough restoration of confidence the movement broadens and purchases are made in the belief that increasing profits will bring greater value to the equities in companies which seem to be headed for an era of prosperity, and much money is borrowed for the buying of the stocks of such concerns. When money rates have begun to turn up, this is taken as indicating the increased use of money in business and as an added reason to be hopeful regarding the outlook for profits. Higher money does not, therefore, have the immediate effect upon stocks that it does upon bonds. In fact, the hoped-for return from stocks is well above the rates which even now must be paid for carrying stocks on borrowed funds. Later, however, the demand for money for use in commerce and industry reaches the point where the banks no longer desire to sell bonds in order to fill the needs for credit. They then begin to discriminate against loans made against stocks as collateral. The interest rates charged for such loans rise and it becomes a less profitable business to buy stocks on borrowed money. At the same period, there is probably some selling of stocks by those who earlier sold bonds in order to get money

to be used in business without going to the banks. On the whole, the stock market begins to disgorge the funds it has been using so that industry may have the money. A liquidating stock market is then commenced.

The new business publication, "The Harvard Business Review," has on its cover the motto, "In industry and commerce all things are become new." Undoubtedly, this refers to the fact that there is slowly emerging a more scientific method of running industrial concerns based upon the use of business statistics and economic training. It would be difficult to impress an old-timer with the soundness of the use of such academic means of controlling a business organization, but the fact remains that it is being done with marked success and with impressive results upon the income account, which, after all, is the final test.

It has been stated that the industrial cycle is more than anything a matter of the sequence of economic events. The study of business statistics is to-day concerned with the discovery of the details of these sequences and the relations between the individual parts of the economic machine. It is broadly known, of course, and this is the general basis of the Harvard Economic Service, that speculation forecasts the activity of business, that the activity of business forecasts the rates for money, and that the latter are a reasonable forecast of speculative activity. Various individual indices reflecting these broad movements have been set up. For instance, the index of speculation is a weighted index made up of bank clearings in New

York City and individual stock prices. The index of business activity contains figures for bank clearings outside of New York City and an index of commodity prices. Finally, the demand for money is measured by the rate for 60-90 day commercial paper and the rate for four to six months paper. These series have been investigated over a long period of time, their seasonal movements studied as well as the long-time, or secular, trend, so that allowance may be made for such movements in the interpretation of current changes. Not only are these indices studied in their broad aspects, but individual series are being studied in relation to each other.

The application of such studies is being made to specific business concerns. Many are studying their position in the general business cycle to discover whether they precede or lag behind industry as a whole in its rise and decline. They are getting a clearer idea of how their raw materials run in relation to general prices, how their sales move cyclically, and how their selling prices move in the cycle of wholesale or retail price movements. They are making the same investigation of their costs, wages, etc. Many have also found it useful to compile their figures and to have them studied in connection with the figures of other concerns in the same business, the results being published for the mutual benefit of all. The American Telephone and Telegraph Company employs a large staff of statisticians who are engaged in studying every aspect of the telephone company's business. They

have even charted the activity of business in separate sections of the United States in order to discover whether there is any order in which the various parts of the country recover from a depression or culminate a period of prosperity. The head of one large manufacturing company has stated that until a few years ago it was more or less inevitable that they should have inventories when they were not wanted and none when they were wanted. Now, however, by the use of business statistics, by the study of the various phases of the company's activities in relation to the cyclical movements of general business, they have been able largely to rectify this situation. In fact, he went so far as to say that in 1922 they were able to forecast their probable sales within one-half of one per cent of the actual sales made. It is inevitable that under such circumstances the income account should be favorably affected.

The stage which the study of economic and business statistics has reached was well expressed by President Lowell of Harvard University.¹ He first distinguished between the exact sciences and the quantitative sciences. The use of physics, for instance, has reached the point where an engineer can calculate with minute exactness the amount of strain which a given piece of steel will stand. The biological sciences, on the other hand, cannot tell with exactness what any given individual will do under a given set of circumstances, but through the study of a large number of cases it

¹Speech made at a dinner in Harvard Club of Boston, October, 1923.

has become possible to tell what the average individual will *probably* do, and this is the basis of the very accurately figured risks of the insurance companies. So it is with the study of business statistics; this is becoming a science comparable to the biological sciences by which it is possible to foretell from a given set of economic factors what the *probable* ensuing situation will be. There is yet to be done a vast amount of research work, but rapid progress is being made.

All of this is introductory to a discussion of the probable future use of this new science in the profession of investment. There has already been noted the broad relationship between security prices and the money market. The Harvard Economic Service has gone further. They have discovered that, with one exception, the year 1919, over a period of years, whenever the rate for 60-90 day commercial paper, after adjusting for seasonal variations, rose a given amount, it marked the end of the rise in bonds; and whenever such rate, similarly adjusted, rose a further given amount, the end of the rise in stocks was indicated. This does not mean that declines immediately set in, for, in the case of stocks, an interval of twelve months has elapsed before the decline commenced, but it does seem effectively to mark the top. Col. Leonard P. Ayres, Vice-President of the Cleveland Trust Co., and an eminent statistician and economist, has made a study of the relationship between the volume of pig iron production and bond prices. To the layman, it would

be difficult to understand why there should be any connection between two such apparently widely separated factors. He found, extraordinarily enough, that in every major cycle since 1883 the top of the bond market was reached *exactly* fourteen months after the low point of pig iron production. On the basis of his discovery he forecast the end of the 1922 bond market in September of that year. The end came exactly at that time and coincided with the Harvard Committee's estimate of a rise in money rates, after adjustment for seasonal variation, large enough to mark the top of the rise in bonds.

It seems, therefore, that the field of business statistics opens wide a source of information which will be useful in the profession of investment banking. There is still much to be done and many relationships yet to be discovered. It is known that those industries which manufacture producers' goods recover from a depression before those which make consumers' goods; it is possible that the securities of companies which manufacture equipment and machinery may begin their recovery or decline before those that produce clothes, food, etc. It is known that the prices of raw materials fluctuate more violently than those of manufactured goods; it is not unlikely that it will be possible to measure the extent to which this is reflected in the prices of the securities of companies which produce or deal largely in raw materials. It is evident that the banking situation has a direct bearing on security prices, but it may yet be possible to discover

whether the condition in the New York banks, the country banks, or the Federal Reserve banks has the more direct and immediate influence. Then there is the possibility of a relationship between the volume of manufacture and security prices; between the ratio of loans to deposits and to the markets; and many others which continued study will bring out.

The advance which has been made in the analysis of general business conditions, and the application of the discoveries to the field of securities, has given a firmer foundation on which to base a professional service in investment matters.

WHICH INDUSTRY?

Suppose now that a study of the general economic situation has led one to believe that the bottom of a depression is near at hand and that a more favorable trend of events is in prospect. It is possible to adopt the general assumption that all industrials will do better, and that securities as a whole can safely be purchased. This is the broad basis on which Mr. Roger Babson rests his advice, believing that if an investor will widely diversify his purchases over many industries and companies he will get a "cross-section" of the market and profit by the average rise of the markets as a whole. But this does not seem to go far enough. Not all industries nor all companies will surely have a prosperous period even should business as a whole be active and profitable. It should be possible to make sufficiently careful studies of separate industries and of individual corporations in order to come to some conclusion as to which ones are most likely to profit by improving conditions, and to weed out those which received such severe blows during the depression that the recovery of their earning power is likely to be slow. It should even be possible to choose not only from the good, but from the best. In other words, there seems reason to believe that an attempt should be made, with reasonable prospect of

success, to locate a cross-section of the best part of the bond and stock markets.

The analysis of the conditions within individual industries includes the investigation of those economic factors with which the average investor is more familiar. The question of supply and demand assumes more importance, and the supply part of it is, during a depression, the more important of the two; for demand one knows is low, and from the conclusion that more favorable times are in prospect demand can be assumed to be in the ascendency. It is well to ascertain not so much present demand and supply but the future demand in relation to the supply. Then there is the question of labor conditions, the capacity of the industry in relation to normal consumption and the prospective competition. Dependence upon foreign trade or the lack of it is particularly interesting now that this is a creditor nation. The financial condition within the various units is of course an essential factor, for if, as in the fertilizer companies and others, the financial strength has been impaired, normal improvement only cannot be expected to furnish the wherewithal for dividends. A very excellent rule of thumb has been to select those companies which have done well in spite of the unprosperous period through which they have been passing, for they have successfully met a severe test. Then apply to these concerns the light thrown upon their future by the study of general conditions. Another rule of thumb is to discover those concerns rich in liquid resources, for these

have the strength to withstand unfavorable events and have at the same time the power to take advantage of opportunities and to forge ahead when the situation brightens; there is nothing quite so valuable during a period of slack business as a goodly supply of cash and credit.

By way of illustration of the procedure to be followed in locating a cross-section of the best of the market, it may be profitable to review the method which was adopted during the Summer of 1921. It will be said that this is after the fact and that it is easy enough to say now what might have been done at that time. The truth of the matter is, however, that the plan about to be outlined *was followed during the Fall of 1921 and the months which followed*. The segregation of the industries naturally comes first, to be later followed by the choice of the corporations.

It will be remembered that the stock market continued to keep the public in a nervous state of mind all during the Summer of 1921, mainly because, in addition to very poor business, there was some evidence that the situation among the New York banks might become crucial. The foreign situation also led many to believe that until it was settled there was no hope of a recovery in the United States. In fact, many felt that economically Europe was about to collapse and would drag this country into the maelstrom. Underlying this was the fact that money rates had been declining during all of the year, bond prices had been rising since June, and in August pig iron production

had increased for the first time since October, 1920. These underlying conditions were those which usually forecast better times. During August, 1921, too, there was announced a government report which indicated a short cotton crop, and the price of cotton received a very considerable upward impetus. The rise in this staple was of noteworthy influence upon sentiment in the South, and also on the North, for the improved buying power below the Mason and Dixon Line was sure to be reflected in more free purchasing not only in the South but in the North. It was evident, therefore, that confidence was returning and that buying from one section of the country was reasonably sure to be reflected in better buying power elsewhere; the influence of the rise in cotton thereby seeping through the whole economic structure of the nation. Increased building operations were also very much in evidence.

General improvement could be expected, but where was it most likely to be best reflected? On the whole, it was well known that, due to the war, there had been a dearth of new building. Since money was in plentiful supply at fair rates for building purposes, it was not a far guess that there would be a great deal of building done, and that those engaged in that industry, or contributing to building, should prosper.

It was also known that for some years the hardships of the railroads had tended severely to restrict their purchases of new cars and locomotives. There was without doubt a very real shortage of railroad equipment. It was only a question, therefore, as to whether

the railroads could pay for their purchases. The Transportation Act had tended to restore to some extent the badly hurt railroad credit; the monthly returns of railway earnings during 1921 had demonstrated that the roads were making great strides toward the control of their expense accounts; it seemed probable that the expected improvement in business would add to their revenues and their net returns; there was plenty of money available, and the record of car trust notes had been so good that these had become a favorite medium of investment. Nothing, therefore, seemed to be in the way of heavy purchases of equipment, and prosperity for the manufacturers of locomotives and cars seemed clearly in prospect.

The railroads, as just indicated, were in a position where their rates were higher than they had been, but their volume of traffic was too low to bring substantial net returns. Costs of material, on the other hand, and wages were tending downward. Costs were being further cut through more skillful operation, the elimination of the unfit employees, and the added efficiency of the remaining workers. It was reasonably certain that a large increase of tonnage could be carried with far from a proportionate increase in operating expenses, and that the increased gross revenues would in large part be saved for net. There remained, however, the very unfavorable aspect of the continued cry for lower rates, and political demagogues still found the railroads a large and easy target for attack in the hope of getting votes. While it is unfortunate that the country as

a whole cannot recognize that it is essential for the transportation plant to earn enough money to assure its growth ahead of the needs of commerce, the security buyer must, nevertheless, consider the influence of political activities on railroad security values. One could, in 1921, anticipate a very much improved railroad earning power, but at the same time was forced to recognize the cloud of uncertainty overhanging the general railroad situation.

Public utilities of all kinds were in much the same category as the carriers. Their costs were being substantially cut while their rates had been increased. Their margin of profit was growing. At the same time, many state public utility commissions were, at least partially, seeing the light and adopting the view that a fair return was essential to attract the capital necessary to expansion. In the public utility field, the hydro-electric companies, particularly if their plants were built in normal times, had been doing well in spite of the difficulties of rising costs, for in their case the outlay for plant is the largest item, and after the plant is built the costs of operation are low, labor and coal being required in negligible quantities. The electric light and power companies dependent upon steam, and concerns making gas, were enjoying a better margin of profit and improving business could be expected to enlarge their output. Such companies seemed to have brighter days ahead. The street railways could also be included among those which had lower costs, but they were experiencing far more difficulty in rais-

ing rates, and, as the larger proportion of expenses went to pay wages, the costs remained relatively high, preventing a sufficiently increased margin of profit to warrant the anticipation of a materially improved earning power.

The fertilizer industry was looked upon as basic and essential to the farmer who, in his then desperate plight, would have need of every recourse to lower costs of production. The leading companies in this industry had, however, been forced to carry the notes of the farmer and to borrow for this purpose in a money market so unfavorable that money probably cost them at least 9 per cent, a heavy charge for long-time loans. The burden which had been put upon these concerns was so great that it was not possible to anticipate earnings large enough to support the heavily increased bonded debt and at the same time pay dividends. A momentary comparison of what were, before the war, normal earnings for these companies, and the income which was then necessary to cover interest and dividends, demonstrated the impossibility of expecting an income from the shares of fertilizer companies until the new borrowings had been substantially reduced. Later it came to light that the entire industry was in a most disorganized condition, and even now it is only possible to assume that its basic character will ultimately be a strong enough force to put it on its feet again.

The sugar industry provides one of the most interesting of economic studies, as it illustrates concretely

the influence of the law of supply and demand, the foolhardiness of governmental interference with economic laws, and the ability of an industry to readjust itself economically if left to its own devices. During the Great War the world production of sugar was materially cut down because of the interference with the growing of sugar beets on the Continent. This naturally restricted the supply of sugar and was an influence tending toward higher prices. The enlarged profits brought by better prices encouraged an increased production of sugar in Cuba, which, for a while, made up a part of the shortage. It was not enough, however, and when the United States entered the War the possibility of much higher prices for sugar was imminent. This government, therefore, arranged to buy the entire Cuban crop at a fixed figure which was not high enough, with the then costs, to encourage any additions to productive capacity. With the ending of the War the fixed price was taken off, the actual shortage of sugar became increasingly evident, and the price soared to record heights. High prices and very large profits again attracted capital into sugar production, which was much increased. The high price restricted its consumption and encouraged the use of substitutes. Sugar which had been sold to Europe was returned here for resale at large profits and sugar from all over the world flowed to this market like a tidal wave. Whereas the low fixed price had failed to limit demand and had restricted output, the high price cut down consumption and brought a supply little short of a

flood. Speculation in sugar had become rampant, much of the product having been hoarded for higher prices. The price began to fall; all the hoarded tons of sugar competed for a market with sugars from Java, Brazil, Peru and elsewhere. The price of Cuban raws fell from around twenty-three cents to less than two cents, a figure below the cost of production. During the Fall and Winter of 1921 the outlook for the sugar industry was black indeed; there was an unsold carry-over of over one million and a quarter tons in Cuba alone. Few, indeed, had the courage to buy sugar securities at this time. After the turn of the year it became evident that the very low price of the product had vastly increased consumption, and that the plantings of cane and of beets were being severely curtailed. The enormous carry-over was being depleted with unexpected rapidity. Clearly, under these circumstances, an improved price for sugar could be expected and profits for sugar producers were less distant than seemed to be the case a few months before. The securities of sugar companies must, therefore, be looked upon as having possibilities.

The automobile industry was exceedingly difficult to gauge. It is a comparatively newcomer to the industrial world, so that there is not available any series of figures on which can be based an appraisal of the probable consumption. In general, some improvement in the business could be looked for on the assumption that industry as a whole was going to improve. It seemed evident, however, that the reaction from the

fierce spending of 1919 and 1920 would tend toward very careful discrimination in the purchase of automobiles and that only the low-cost manufacturers, those with large-quantity production, would be able to make any profits. The inability to judge the future of this industry led one to be very wary of the securities of motor companies and of those dependent upon the industry. It was not until considerably later, in 1922, that the actual business being done by the motor companies demonstrated the fact that, measured by the demand for automobiles and the evident ability to pay for them, there was in reality a shortage. The unwillingness to assume the risk of buying the securities of companies in an industry whose future could not be measured with reasonable accuracy deprived the careful investor of a chance for the large profits which have accrued to those who took the greater risks.

The oil industry was, late in 1921, one which seemed to hold promise of better times. It had been one of the last to feel the effects of the depression, and this indicated that quite possibly it would not be so seriously affected as others and would be quick to recover. This belief had further foundation in the fact that there had been a large increase in the use of petroleum products in automobiles and tractors, and in locomotives and oil-burning ships. There was a large supply of oil on hand, but improving business would probably increase consumption sufficiently to work off the excess stocks and bring good profits to companies which produced, refined and distributed oil products.

The event proved that the expectation of better profits for such companies was well founded, but although consumption increased enormously, the sudden flow of crude which came from the new fields in California late in 1922 and early in 1923 cut short the prosperous career of the oil industry. It is possible now (October, 1923) to assume that the prevailing low prices will discourage new drilling; that the very intensively drilled new fields in California, where wells are in many cases only a few feet apart, will cause these sources to be quickly depleted; and that the continuing heavy consumption will, all combined, bring a fairly quick recovery in the business, provided no other new and prolific fields are in the meantime discovered.

If, in the period when the depression seemed about over, it was believed that there would be good business for builders and for the makers of railway equipment, it naturally followed that the steel industry should be counted upon to be prosperous. The capacity of the country to produce steel had, on the other hand, been much increased by the demands for war material and competition for business was sure to be keen. Care in the selection of the best company in the steel industry was clearly required.

The fall in the price of leather had been drastic and the industry had suffered severely. Improving business with the enhanced buying power of the nation would probably improve the demand for leather. But recent years had brought quite a change in this industry. Heavy killing of beef, of which hides are a

by-product, had added considerably to the stock of hides on hand. In order to prevent their deterioration the packers had found it necessary to tan these hides into leather. On the other side, the two largest consumers of leather, Endicott-Johnson and the International Shoe Co., in order to make themselves as self-contained as possible in the manufacture of shoes, had also begun to tan their own hides. This left the tanners faced with a large stock of leather and deprived of two main sources for business. It was consequently very questionable whether the leather industry could be looked upon as a favorable medium for investment.

The companies making electrical machinery were evidently in a favorable situation. The high cost of labor during 1920 led many manufacturers to fortify themselves as far as possible against a repetition of high wages by a more thorough use of labor saving devices. This gave greater force to the saying that we are in an Electrical Age, for electricity is the great saver of labor. The later and unexpected activity of business demonstrated that the restrictions on immigration have made our labor supply short, adding strength to the conviction that the electrical companies had a rosy future.

A large industry which in the past had had a successful record was that engaged in the production of copper. As a raw material the price of this product has had rather wide fluctuations. In 1921 it was unusually depressed, so much so in fact that most of the domestic producers had been forced to close their

mines. The supply of copper was very large and the heavy dependence of the industry upon export trade gave reason to believe that the recovery would be rather slow. The closing of the mines in the United States indicated that the supply of new copper would be sharply curtailed and better business in general would increase the consumption somewhat. The work of the Copper and Brass Research Association was discovering new uses for the red metal which later helped to increase the domestic consumption. It was probable therefore, that the industry could look for some improvement, but the extent of the betterment would have to be later determined by the trend of exports. Another factor entered into the situation, this being the vastly increased production of low cost copper in South America and also in the Belgian Congo. The copper industry could, in 1921, be looked upon as having possibilities, but there were elements of uncertainty which required watching.

Other industries could have been reasonably carefully analyzed at that time. The textiles would probably improve with general business, but those in New England, which might have labor difficulties, were not in the same position as those in the South which are near their source of supply of raw material, cheap labor, and cheap water power. The chemical companies (not the fertilizers) were engaged in a business of broad basic importance with good prospects. Smoking seemed rather to have increased than to have decreased during the depression; the tobacco com-

panies had not received the severe blows felt elsewhere; these companies had nothing to handicap their taking advantage of a better situation. Shipping, on the other hand, was much depressed by the paralysis of world trade and the over-production of shipping during the war, and would take a long time to recover. The rubber companies had on the whole over-expanded, had suffered heavy losses through the drastic decline in the price of crude rubber and of cotton fabric, and were faced with the prospect of continued low prices because of the difficulty of controlling the production of rubber, for once a rubber plantation is planted the trees continue to yield, making it more difficult to curtail supply to match demand. Chain store companies, on the other hand, had demonstrated during the depression the economic soundness of their foundation. Being able to buy cheaply in large quantities and to operate at a low cost per unit of sales, they have reduced the cost of distribution and in passing a part of their saving on to the consumer they have attracted a large following. Their enormous and rapid turnover has to some extent eliminated inventory problems and has made possible good earnings even in the worst of times. If these stores could do well during a period of very bad business, they had passed an acid test.

A summary of the general situation should be followed then by a careful study of the separate industries in order to determine which are most favorably situated. Of course, some of the conclusions

were more or less evident on the face of things, but detailed work was nevertheless valuable in discovering many factors, not quite so evident, but which notwithstanding were of large importance. The study made during the Fall of 1921 disclosed the probable bright future of those who manufactured building materials, railway equipment, chemicals, and electrical machinery. Chain store concerns seemed in particularly good shape, as were also the tobacco companies. Later developments warranted the addition to the list of the sugar producers, and makers of automobiles and their accessories. It was evident that the electric light and power companies would do well, but that the street railways were still to be faced with difficulties. Very fair prospects were seen for the railroads as a whole, for copper, oil refiners and distributors, textiles and for steel. But the fertilizers were eliminated as were the leather, shipping, and rubber companies. Leaving the industries and glancing over a list of prominent companies also brought to light many so-called "specialties" which were in a good position, and others which were not.

The question then arose as to which companies would best serve as mediums through which the prospective prosperity of the various favorably situated industries could be shared.

ANALYSIS OF COMPANY REPORTS

The final choice of the company whose securities shall be the vehicle by which one would assure himself of an income, and so far as possible reasonable appreciation in value, involves the analysis of company reports. Every individual has perhaps his own way of making such analyses, and each will put a different weight upon the various items disclosed in these reports. In the main, however, all follow pretty much the same procedure. The degree of skill with which such analyses are made and the results obtained depend very directly upon the detailed manner in which the work is done and the thoroughness with which each item is scanned and weighed in its relation to the others in order to get at its true significance. It has been remarked earlier, and can be stressed at this point, that there are many reports which contain items whose true meaning is not sufficiently clear. Each one of these casts a shadow over the opinion formed unless clarification has been obtained from some one in close touch with the affairs of the concern under investigation. It is not always possible to get the desired information, and unless there is some confirmation of the conclusions arrived at in a knowledge of the management's conservative policies or in its past record, the securities of such

companies must be passed by in favor of those concerning which guesswork is largely eliminated.

Occasionally company officials who do not wish to talk about its affairs take refuge behind the statement that they "are running a business and are not interested in what the securities are doing." This sounds very well, but in the long run the securities are a pretty fair measure of the success with which business is managed. It is not necessary for the officials to be interested in temporary movements of the bonds or stocks or in their manipulation, yet they cannot be otherwise than concerned with their reflection of the company's business. It is said that the officials of the Corn Products Refining Company are directing all their efforts to making its common stock as valuable as possible, which is to say that they are handling the business and financial affairs of the company in such a way as to make the property as valuable as possible to its owners. This is a frank recognition of facts. It is not necessary to disclose trade secrets and quite in order to refuse to answer any leading questions on this ground, but experience has shown that more often than not the officials who profess to have no interest in a company's securities, and refuse to help the security analyst as far as they can, fear the asking of questions which would disclose some definite weakness in the concern's position.

Analyzing a company report is really nothing more than a study of the earning statement and the bal-

ance sheet in connection with each other. Such a study must include a comparison with those of earlier years in order to determine the progress, or lack of progress, which is being made and to come to a conclusion as to the stability of earning power and the character of the management. Naturally, too, such a comparison discloses the normal and assists in a judgment as to whether the current report covers an abnormal, normal or subnormal year of earning power. It should also be remembered that company reports tell a story of the past and that their main usefulness is the basis of a forecast of future earning power, which is all one is interested in as an investor.

It is difficult to say which is the more important, the earning statement or the balance sheet. It is really necessary to use both and to analyze the features of each in the light of the other. The fundamental of all security values lies in the earnings; for it is from profits that one receives interest and dividends, and it is profits which assures the credit that forms so large a part of security values. From the point of view of the economist it is earning power which determines the property value. One hears great stress laid upon "book value" and property value in the judgment of securities, but really such things mean little or nothing. There is the same fallacy in this belief as there is in the farming country. Many farmers who paid high prices for their properties complain that they cannot earn a fair return on the value of their land. They have put the

cart before the horse. The value of the land depends upon what one can make it earn, for this is the basis on which a buyer will name the price he will pay for it. So in buildings; the value is not the cost of the land and the building; the value depends upon the return which the land and building can be made to bring; if conditions change and earning power falls, the value goes down. So, too, with securities; the earning power determines the value; the cost of the properties has to do with value only in so far as it discloses a past earning power which has been expended in fixed assets, or the policies of the management.

There are extreme examples of this fact. The New York, New Haven and Hartford Railroad owns railroad property which the Interstate Commerce Commission has valued at a sum in excess of all the capital liabilities of the company. But at present the earning power is not there and the stock has for a considerable period been selling below 15 and has been as low as 9 $\frac{5}{8}$. Against this there is the Woolworth Company which has been holding tangible property worth about \$56,000,000, this amount being exceeded by the issued securities, and which has until recently carried in its balance sheet an item for good will as high as \$50,000,000. The book value of the stock on December 31, 1922, was \$70.25 in tangible assets but this company earns handsomely and its stock at this writing is selling at 275. In the railroad field again there is the Harlem River Bridge which serves as the

entrance to New York City proper for both the New Haven and the New York Central. The earning power of this short piece of track, if segregated from the rest of the terminal and separately owned, would in a year be a very large percentage of its original cost. How would one go about giving it a value? With the segregation from the Reading Company of the Philadelphia and Reading Coal and Iron Company, one reads much of the value of the latter's coal properties. They are said to contain 1,000,000,000 tons of coal and to be worth \$100,000,000 at a conservative estimate. This company mines approximately 10,000,000 tons of coal a year. In thirty years it will have mined 300,000,000 tons, leaving 700,000,000 tons in the ground thirty years hence. It has been asked, what will one pay to-day for that 700,000,000 tons? It is manifestly impossible and useless to figure a price. Thirty years from now conditions may be so changed that it will be worthless. The value of the Philadelphia and Reading Coal and Iron Company's property is of no use in estimating the value of its securities. It is only the company's earning power which will be the determining factor, except in so far as the size (not value) of the coal reserves assures the possibility of mining coal indefinitely.

The earning statement would seem, therefore, to hold the preëminent place in an investigation of a corporation's securities, but what one is after is the basis of a judgment as to future earning power, and as to the ability to pay interest and dividends after

they have been earned. The balance sheet is far more important for this purpose than is the statement of profit and loss. It should consequently receive the closest attention and be carefully scanned in connection with the report of earnings. The two together can give a fair picture of managerial ability and conservatism and a good ground, in connection with anticipated industrial conditions, for a conclusion as to the company's future prosperity—or lack of it. Of course, each report as a whole must take into consideration the requirements of the particular business in which the company is engaged.

Not all profit and loss statements contain more than a report of net earnings, income from outside sources, total income, and the ordinary deductions therefrom. Such a report calls for an even closer study of the balance sheet in order to discover what reserves have been laid aside, what deductions have been made for depreciation, etc., before the figure for net income was arrived at. Where a full statement of gross income and of expenses is given it is of great value. From such a report can be obtained evidence of the growth of the business or of the efficiency with which it is managed. It is always interesting to know whether a company is increasing its net income through a greater output or by the reduction of costs, or both. From such figures it is possible to discover the operating ratio, that is, the proportion of gross income which is consumed by expenses, and to compare this with other companies similarly situated. A comparison of this

kind often discloses the relative efficiency of the management or the relatively favorable situation of the different companies in the same line of business. In view of the fact that in times of declining business activity sales usually fall off before expenses can be controlled, the operating ratio is to some extent a measure of safety; if the ratio is high a comparatively small reduction in gross will be felt in a large percentage reduction in net and possibly cause its complete disappearance, while if the operating ratio is low a greater percentage reduction in gross can be sustained before the net disappears.

Most reports of earnings include the amount deducted for depreciation. If not, one must search it out in the balance sheet. The item is important in its bearing on the future. If ample provision has been made for the wear and tear on plants the holder of the company's securities can feel assured that he is not being paid sums which should be used to maintain the property's power to earn profits; but if the sums deducted for depreciation are insufficient, the security owner may suddenly discover that his source of income has disappeared and he will meet a fate similar to that suffered by the investors in the Gould railroads. Opinions differ as to what is proper depreciation. Unquestionably, any conclusions must first consider whether there is constant maintenance of the property, the cost being charged to operations, in which case the depreciation may be negligible; or whether the property includes much machinery which in a few

years may be obsolete and of necessity replaced in order to keep up with the procession. In the latter case the sums laid aside for depreciation or obsolescence should be relatively large and kept in a fairly liquid form; it does not help the stockholder to make heavy charges for obsolescence and when the necessity for resorting to the reserves arrives, to find it in fixed form and unavailable for the purpose. It is a different matter, of course, if these sums are used from year to year to keep the plant strictly up to date.

Reports of earnings commonly state that so much has been earned and that this sum is equivalent to such and such an amount on the common shares. One needs to know whether this is strictly so; in other words, whether the amount named is actually available for dividends or for use in adding to the earning capacity and value of the property. Have taxes been provided for, have all deductions been made, such as those for bad debts, inventory and other adjustments, sinking funds, etc? It is essential to know these things, and it may be found necessary to dig them out of the balance sheet or to ask some officer of the corporation to amplify the information.

The importance of the discovery and weighing of these items is reflected by the fact that practically every company whose securities are among those known as high grade have been those which have in the past been the most conservative in building up their reserves against contingencies and in writing off all losses and reductions in asset values. As a general

rule, the greater the use of current profits for the preservation of and for additions to earning power, the larger have been the ultimate dividends and the greater the value of the securities. It is not too much to say that, from the point of view of the investor, the deductions made from earnings for conservative purposes point very directly to the value of a security as an investment.

And the searching out of these deductions for possible contingencies often leads to the discovery of an earning power which was generally unappreciated. There are a number of companies which charge into their operating costs sums of substantial size for reserves of one kind or another. These are, therefore, not apparent on the surface. To find them out often results in giving an entirely different impression of the whole situation. For instance, the Allied Chemical and Dye Corporation in 1922 reported earnings but very little in excess of its dividend payments. To the casual observer, this was unfavorable. But those who took the trouble to discover the large reserves to which earnings had been devoted before arriving at the net available for dividends quickly saw the true situation.

A good rule of thumb is, then, that the greater the proportion of earnings used for reserves, the more conservative and valuable the company's securities.

As was remarked earlier, the balance sheet is the main instrument used to arrive at an opinion as to future earning power, although past earnings naturally give some foundation for such an opinion. In judging

a balance sheet, the first general question is, are the assets worth the values stated, and do the liabilities include all the obligations of the company?

The property account does not give any direct clue to the value of the securities, but it gives material from which it is possible to come to a conclusion as to managerial ability and financial conservatism. Its true economic value lies in the earning power itself, but the item gives some clue to the policies of the management and discloses whether in the past net income has been devoted to building up the property. It also gives ground on which to base a decision as to the sufficiency of the reserves for depreciation, etc. It is not alone a sound basis for the security of bonds, for if the earnings disappear and the property falls into the hands of the bondholders, they may or may not be able to realize dollar for dollar from the plants, even though their cost was well above the principal amount of the bonds. The manner of handling the property account is of more importance than the figure at which the properties are carried.

The current assets call for more detailed treatment, and need strict appraisal. The cash is, of course, worth its full figure. The question is whether there seems to be enough. This will depend upon the size and the type of the business, and will often vary with the seasonal trend of the business as well as with the due dates of interest or dividend payments. The notes and accounts receivable may or may not be worth the figures stated. What reserves have been set against

them for doubtful accounts? Inventories likewise; how are they carried, at cost or market? These may increase or decrease in value; what does a study of the business cycle indicate as to the trend of prices in general, and what does the study of the industry disclose as to the probable course of the prices of its particular commodities? Also, is the business one of quick turnover of inventories such as in baking companies and in chain stores, or is the process of manufacture a long one calling for materials to be held over many months as in leather and heavy machinery. Securities are often held; are these easily marketable and, therefore, good current assets, or would they be difficult to sell, in which case they must be set aside in figuring the working capital? Are they carried at cost or market? Some companies are known to carry their own securities, purchased through sinking funds or held in the treasury, as current assets; this is a questionable policy and must be taken into account in figuring actual available quick assets. All these things are required in order to discover the company's true working capital position.

The deferred assets in some balance sheets run into large figures. Where they are payments made in advance they assume the nature of receivables and are almost current. But where, as is so often the case, this item is made up largely of debt discount, they become a sign of weakness. The amortization of the discount at which securities have been issued can logically be spread over the years which the bonds have

to run before maturity. But it is, nevertheless, a fact that the discount at which bonds have been issued is a deduction of surplus, for it is carrying as an asset something which is far from being an asset, and to the extent to which it thereby increases the surplus it does so falsely. Many companies recognize this and write off bond discounts from surplus at once; these will usually be found to have high credit. Many others do not and those which carry this item as an asset not invariably, but often, indicate weakness. To find this item in a balance sheet puts one on warning that there may be weaknesses elsewhere and should increase the detail with which the record is studied.

The liability side of a balance sheet can be assumed to be at least as large as it is stated. It is difficult to do so, but, if possible, all contingent liabilities should be discovered. The importance of this was illustrated in the case of the Columbia Graphophone Company which has just gone into receivers' hands. The management of this concern, in a burst of enthusiasm in 1919 and 1920, made large forward contracts for materials and parts. For a very long time after prices began to decline and business to fall off this company was forced to continue to buy and to borrow the money with which to make payments. Gradually the contingent liabilities became bank loans, the inventories increased in quantity but decreased in value. In like manner, what securities, not included in the balance sheet, have been assumed or guaranteed? If there are any such they must be looked into to see

whether the contingent liability will become real and a drain on the parent concern. Such a case is that of the Interborough Rapid Transit and its guarantee of the Manhattan Elevated Company stock; the latter could not earn enough to make good the guaranty.

The statement of capital liabilities quite naturally discloses the fixed charges with which a company is burdened. It also should be used to determine the ratio between bonds and stocks. If the stock issue is small compared to other outstanding securities, as earnings grow they will mount up fast on the common shares, but in like manner in bad times the per share earnings will fall as quickly. Such stocks are violent market movers and lack stabilization, and the equity behind the bonds is a variable factor of safety.

The liabilities also include a statement of the reserves unless these have been included as deductions from assets. This subject has already been covered.

Probably the most essential element in a balance sheet, and the one which throws the most light on the future, is the statement of working capital. This figure is the sum of the current assets (after pruning as above described) less the current liabilities. The ratio between the two items is of importance, for if the former exceeds the latter by very little a small percentage decrease in the asset values may wipe out the working capital and bring an excess of current liabilities, but if the assets are several times the payables the margin of safety is so much the greater. Naturally the working capital must be judged in rela-

tion to the requirements of the business, the size of gross sales, the rapidity of turnover, and the probable need of cash for property account. The quick assets constitute the funds from which must be paid interest and dividends, they are the buffer to hard times, and in periods of depression they are the means by which opportunities to acquire bargains are availed of. The details of the working capital position are, therefore, fundamental to a judgment as to the probability of dividends, and as to the financial conservatism of the management.

The conservative handling of the reserves and the relative sufficiency of the working capital are probably the two most significant features of companies whose securities have reached the plane of high grade investments.

Many investors who are accustomed to thinking of stocks in terms of a designated par value have been confused by the growing use of shares without nominal or par value. The difference between the two is mainly one of bookkeeping. Whether shares have a nominal value or not, each one represents a proportionate interest in the assets and earning power of the company. When par value stock is issued below the stated value it has usually required the padding of the asset side of a balance sheet with good-will or other intangible values. The necessity of this is obviated by the issue of no par value stock, but in the case of this type of security it becomes necessary to assure oneself that the price is not well in excess of the value which each

share represents. By way of illustration, reference can be made to a company which issued one no par value share of each dollar of cash in the company, but the stock was offered the public at above \$15 a share. The point is that whereas in nominal value stock the intangibles are put in the balance sheet or other assets are overvalued, in the case of no par value stock the market price may represent much intangible value not otherwise disclosed.

There are many other details which could be included in a discussion of the analysis of company reports, but the foregoing should indicate how great is the necessity of calling upon one trained in the work for a judgment of security values.

In the previous chapter, the conclusion was reached that the railroads could be counted upon to do better. Even though there would be nervousness over possible legislative action, the investor should include some rails in his list for a number of reasons. In the first place, he was pretty well guarded against further depreciation by the very lowness of prices at the time. Secondly, proper diversification seems to call for some inclusion of the securities of this enormous division. Thirdly, through the monthly reports made to the Interstate Commerce Commission, both of earnings and operating statistics, one is enabled to keep closely up to date in regard to the situation in any railroad property in which he is interested.

Government regulation has put the railroads in a very different class from other securities. Combined

with the fact that railroad stocks and bonds constitute so very large a part of the invested capital of the country, it seems pertinent to give briefly an outline of the manner by which railroad securities can be judged. There have been published many treatises on the analysis of railroads, but, although these will be valuable to one who wishes to become well posted, the following, it is hoped, will give a rough picture of the problems involved.

Before undertaking to outline the study of a railroad, it must be made clear that no one factor in a road's situation will alone mark its earning power or the efficiency of its management. Each factor must be weighed in relation to the others with particular reference to the situation surrounding the carrier being studied.

The primary consideration is the question of traffic. Where is the road situated and does the territory it serves warrant the belief that it can find a good tonnage to move, and is the community sufficiently prosperous to buy elsewhere and provide an incoming traffic? A railroad sells transportation; an analysis of the traffic possibilities is like figuring the probable gross sales of an industrial corporation. But the study of the traffic has also several other features. Does the road move its tonnage predominantly in one direction or is the movement of traffic well balanced in both the directions in which it runs? If the former, it means the bringing home of empties with no return for this work; if the latter, it means a better utilization of its

plant and equipment with consequent earning power higher than for a road not so fortunately situated. The character of the tonnage is of interest. Is it of the low grade variety which can be moved in quantity in full carloads, or is it of the higher grade such as merchandise which often moves in less than carload lots. The former will bring lower rates than the latter, but is less expensive to handle. The diversity of the tonnage must be studied so that one may know whether the road is heavily dependent upon one industry, such as the anthracite carriers, or whether it will have other industries to fall back upon in case one or more is temporarily depressed. Finally, the density of traffic, which is technically the tons moved one mile per mile of road in a year's time, is an important measure of the probable earning power of a railroad. The density indicates the use which is being made of the plant and is roughly parallel to the inventory turnover of the merchant. Other things being equal, the greater the density the larger the earnings of the property will be.

The next problem is the ability of the road to carry the traffic offered and to carry it cheaply.¹ The facilities for moving tonnage depends upon the roadbed and rails and upon the sufficiency of cars and motive power. The tendency of the day is toward heavy trainloads, for thereby the greatest amount can be moved at the least expense per ton per mile. Heavy trains call for

¹ When one speaks of cheap operation of a railroad it is in the comparative sense, for, of course, government control of rates and wages to-day largely controls both the income and expenses of the transportation machine as a whole.

cars of large capacity, locomotives with great power, and massive rails laid upon good ballast. Of course, the combination of these factors must be suited to the character of the tonnage ordinarily moved; each road is differently situated, but a knowledge of car capacity, locomotive tractive power, and weight of rail, used in connection with the type of freight carried, is a necessary background to a judgment of a road's ability to carry its tonnage and to make money. For the same reason it is well to know how much equipment is owned; whether it is enough or not is usually disclosed in its outlay for hire of equipment. Finally, the condition of the equipment not only has a bearing upon the ability to carry freight, that is, to sell transportation, but it also indicates whether future earnings are going to be devoted to rehabilitation of equipment or will be carried into net and become available for the securities. Equipment in bad condition militates against receiving traffic or adds to hire of equipment outlays, and enlarges maintenance expense. Since all of these reduce the net return, a knowledge of the condition of equipment is a prime essential in forecasting a particular railroad's earning power; it is probably the most important single item to be looked for in judging the future earning power of a railroad.

The physical features of a railroad have a large bearing on its ability to operate cheaply. For instance, the steepness of grades and the degrees of curvature in its line will influence the expenses. Both of these will limit the loading of trains and may make necessary the

use of helping locomotives. Either will increase the operating ratio. The average length of haul and the frequency of terminals influence greatly the earning power of a railroad's plant. Any given piece of tonnage must be handled at the receiving end and at the delivering end of a trip, and the transportation is paid for roughly on the basis of the length of haul.² The costs of loading or unloading are equally great whether the haul is long or short, so that the long haul is naturally more profitable than its mere length indicates. A road which is so situated as to have a long average haul per ton carried, other things being equal, will be the better earner. Conversely, the road which has frequent terminals at which trains must be broken up and remade is handicapped through the consequent additions to costs. Such is probably the answer to the New Haven situation; the densely populated New England district with attendant short hauls and frequent terminals, has made railroad operation far more costly than elsewhere. Contrariwise, the Union Pacific with its long bridge line and practically no congested terminals can operate at a comparatively low cost. Although no one set of figures in itself gives proof of managerial ability, no one does more so than those which disclose the length of time that cars are delayed at terminals and classification yards.

The proportion of branch mileage is a matter of

² This is a very general statement, for, as is well known, there are many hauls of great length on which the rate is lower than one of shorter distance, but this cannot be discussed here, and for the present purpose the remark is sufficiently accurate to make the point.

interest which must be considered in weighing railroad statistics. Such mileage often adds to plant account without proportionate additions to gross or net earnings. And the branch mileage often warps the statistics of a road's operation. For example, the density of traffic is figured on the number of miles operated; if one road has a large number of branch lines its density may be well below that of another road with no branch lines, but its actual earning power nevertheless as great or greater.

Part of the general background, which is of consequence in studying a railroad report, is the question of how much of the total traffic is originated, how much terminated, how much received from connections, and how much is through traffic. Originated tonnage involves certain costs of collection, etc., but gives also in many cases the right of routing and of obtaining a long haul. Terminated traffic involves the costs of delivery. Both bring delays in the movement of cars and tend to tie up equipment, thereby lessening the full use of cars and bringing additional charges for switching, etc. Because a road is not responsible for the loading of tonnage received from connections, the proportion of this character of traffic to the whole must be taken into account when analyzing operating statistics, particularly the average car load. The amount of through traffic is rarely published, but, if known, it is also of value in the use of statistics of operation, for the cost of handling through cars is probably least in proportion to the income from such tonnage.

Operating statistics, taken in conjunction with the operating and traffic conditions of a road, throw much light on the probable earning power and the efficiency of the management. But it can be stressed again that no one series of figures alone measures either item, but must be considered with the others. The average carload roughly measures the extent to which the equipment is fully utilized; a full car is very little more costly to handle than an empty one. The average trainload is another figure of like significance; a comparatively heavy train will take but little more fuel and no larger a crew than one which is light, and the gross is thereby increased much greater than are expenses. The average number of miles per car per day is a partial measure of the efficiency of railroad operation and indicates how well the plant and equipment is being utilized, as well as the probable speed of terminal handling. But the figure must be used with caution; an average movement of sixteen miles per car per day on an originating and terminating road like the Pere Marquette cannot be compared to the sixty to eighty miles obtained by a bridge line like the Union Pacific. Locomotive miles and train miles are significant when taken in connection with the tonnage moved; if locomotive miles decrease or increase faster than train miles there is had some proof of improving or lowering efficiency, for, if locomotive miles increase less than do train miles, it indicates a better use of motive power, and vice versa. The increase or decrease in switching locomotive miles may be due to the

amount of traffic handled or it may be due to the efficiency with which cars are passed through terminals, the use of through trains, etc.

The number of operating statistics which indicate this or that feature of railway operation could be largely increased, but the above are those which best give the desired results. With a background of physical characteristics, operating and traffic conditions, and statistics of operation, one is prepared to arrive at a judgment of earning power and the efficiency of a railway's management, and to proceed to study the reflection of these factors in the statement of earnings.

The usual monthly earnings reports made to the Interstate Commerce Commission include first a statement of the receipts from freight and from passenger traffic; it is interesting to notice the proportion each bears to the total. Then follows the amounts spent for maintenance of way and for maintenance of equipment. It is difficult to measure the adequacy of the first of these two items without a knowledge of how many miles of new rails have been laid, how many ties placed, and how much ballast laid or renewed. And even with these figures the layman can only guess at the thoroughness of the maintenance of way by comparing these figures with former years, or on a per mile basis with other roads similarly situated. The sufficiency of maintenance of equipment expenditures can be fairly well judged by reference to the figures reported for the percentage of locomotives and cars held for repairs. Some use a figure which is the percentage

of gross revenues consumed by maintenance. Comparing it with previous years, this is a good general measure of the maintenance done, for, of course, increased revenues mean larger use of the railroad plant and greater wear and tear on the property; but the figure must be used carefully as it can be misleading. The proportion of gross used for upkeep may be reduced by a greater volume of traffic, by increased efficiency in the maintenance department, or by inadequate expenditures. In any case, from the point of view of future earnings, a determination of the adequacy of maintenance is probably the most important single problem.

The usual report also includes a statement of traffic expenditures, a comparatively unimportant item, and of the cost of conducting transportation. In the latter is included fuel and the labor costs of train crews, station agents, loss and damage, etc. It naturally rises and falls with the volume of traffic so that the figure which shows the percentage of gross revenues used in carrying the traffic is particularly interesting, especially when compared to former years. Occasionally such a comparison brings out facts of real significance. An example of this is the case of the Wabash during 1923; for the first nine months of this year the Wabash had, like all other roads, a very marked increase in traffic, but its costs of carrying the tonnage increased only a few hundred thousand dollars. Certainly this shows a striking improvement in efficiency and a great ability to control expenses.

The total of expenses and the proportion these bear to gross revenues (the operating ratio) can only be considered in the light of the conclusions drawn from the separate items which go to make up the total. The operating ratio may be low, due to efficiency, a favorable location, good operating conditions, a large volume of traffic, or to skinning the property. The point is to find out not only what the ratio is, but also what makes it what it is.

Like any other corporation, the payment of interest and dividends depends not alone upon present earnings, but as well upon financial strength. A railroad's balance sheet is a complicated thing, but it must be studied with as much care as any other, and the items given proper weight. Railroad accounting methods differ somewhat from the usual and this must be borne in mind.

Under the Transportation Act of 1920 the property accounts, or rather property value, were given an importance which is not so true of industrials. The policy was adopted of granting rates which would yield a so-called "fair return" on the value of the property devoted to transportation purposes, the value to be determined by appraisal. Even though one may not be able to support the economic soundness of this method of rate making and would prefer to have rates determined on the basis of the demand for transportation facilities and the costs of rendering railway service, the fact remains that the present or prospective railroad security owner must consider property

value in order to determine how much his road may (not can) earn before being forced to share the profits with the government.

The working capital of a railroad is not so vital a matter as it is with an industrial corporation for the reason that the current assets are in the main cash items and reasonably good accounts, and do not include inventories in which large losses may be received. Because railroads do a business based almost entirely on cash payments, the working capital required is but a small percentage of the total revenues. But it is nevertheless true that the carriers with the highest credit are those which have the largest working capital. These are the ones which can weather a severe period of poor earnings and maintain dividends; and these can take advantage of a period of low prices in which to stock up with materials at bargain prices, thereby reducing their average costs. Certainly the financial strength consequent upon a sound relation between current assets and current liabilities is one of the reasons why Atchison, paying only 6 per cent, sells near par, less than fifteen points under Delaware and Hudson, which pays 9 per cent; the former has large cash reserves while the latter's current liabilities, on December 31, 1922 (the date of the most recent annual report) exceeded its quick assets.

Many railroads own a comparatively large amount of securities which can be carried in the balance sheet in three ways. Because the published reports do not always differentiate clearly between them, it is well to

be sure that the item "investments" is properly interpreted. Nearly every road owns some securities of affiliated companies; these are largely the interest held in terminals and other essential parts of the system, either jointly with others or wholly by itself. No great importance need be attached to these; they are really part of the property account. Many roads hold large blocks of securities of other roads, acquired during the reign of the "community of interest" idea. These are strictly investments and must be valued as are those of any other company. In like manner, the holdings of tractions and other concerns, the ownership of which was originally designed to bring traffic to the road, need to be carefully appraised. Finally, some very strong roads include under "investments" large blocks of Liberty bonds and other United States Government securities. These can really be considered as current assets and included in the figures which are used to determine the working capital.

On the liability side of the balance there is nothing which differs essentially from that of an industrial except that the tax liability is usually carried under the deferred items. Since nothing is surer than death and taxes, this liability would properly be considered as current and deducted from the working capital.

The balance sheet of a railway company, outside of the property account, can on the whole be studied like any other balance sheet, and more or less the same results be obtained. It is equally valuable in disclosing how conservative is its management.

In the matter of management, many have the idea that its character is more important to an industrial than to a railroad. Perhaps this is because in an industrial corporation the management can make or lose money more quickly than in a railroad whose income depends largely on general conditions and the pleasure of the Interstate Commerce Commission. It is, nevertheless, true that management can make or break a railroad. Competition for business is keen; the road which can move its cars the fastest and can give the best service in the placing of cars for loading will get the business. And the building of a railroad organization is a matter of years of work requiring the highest possible executive ability. So, too, in its relations with the public, the management which has been able to build up good-will among those dependent upon its service will have the fairest treatment. Management in railway companies is of just as great importance as in any business, and probably greater, for the industry is so vast and complicated.

The analysis of company reports, both railroad and industrial, is a complicated process which brings the best results when done with patience and care as to details. It is strictly the job of a professional, one trained in the work and who, through the study of many such reports, can mentally compare each with others he has previously analyzed. Such comparisons lead to valuable conclusions and give the soundest basis for the appraisal of securities in the present and probable future. Combining the conclusions reached in

regard to management and financial strength with the anticipation of future business conditions, generally and in the particular industry, one has a fairly solid ground on which to base a forecast of the future prosperity of a company.

WHICH COMPANY?

Having outlined the methods by which company reports are analyzed and how it is possible to go about ascertaining the probable future of any particular concern, it is useful to go back again to the example furnished late in 1921 and early in 1922. It will be recalled that there was a background of expected general economic improvement which would be felt particularly in those industries connected with building, the manufacture of railway equipment, in public utilities (especially the hydro-electrics), the makers of electrical machinery, chemical manufacturers, and others making or dealing in merchandise or more or less general consumption. To a slightly lesser extent, it was reasonable to suppose that the railroads would have better net earnings and that the copper and oil producers would likewise recover fairly well. In addition it was quite likely that a number of so-called "specialties," those dealing in special products, would be facing greater prosperity.

In reviewing this period, and the position of certain companies at that time, some unfavorable features are commented upon. It is desirable to bear in mind that the intervening period may have corrected many of these, and that no criticism of present-day conditions is intended.

Because it is so large and important a division of general industry, the railways merited first attention. Which of the railroads seemed the most likely to furnish sound security in present or probable future earning power? As has been pointed out, there must be a favorable background of prospective traffic, and operating conditions which will not bring unreasonable costs. The New England roads would undoubtedly have the traffic, but the development of the territory has been so great that it is much like one large terminal with consequent costs. This district is also marked by heavy competition from trucks and water lines. So the roads in that district must be eliminated.

The trunk lines serve a territory which has been well developed industrially, which would probably be prosperous and would not have the operating difficulties of New England. There should be good tonnage offered the roads and excellent prospects of much coming in return to the communities along their lines. New York Central, Baltimore & Ohio, Pennsylvania, New York, Chicago & St. Louis, Wabash and the Erie should anticipate better use of their plants. So too with the coalers, for active industry means the use of fuel. This gave hope to Reading; Central of New Jersey; Delaware, Lackawanna and Western; Lehigh Valley; Delaware and Hudson; Chesapeake and Ohio; and Norfolk and Western; in fact, coal is so large a part of the tonnage of all roads that the increased use of fuel would help the railroads generally.

In the Northwest there were certain unfavorable

features, particularly the competition with the Panama Canal and the refusal of the Interstate Commerce Commission to restore the rates which formerly enabled these roads to meet this competition; and the prevailing unrest and disorganized industry associated with the Non-Partisan League was then having bad effects all through that territory.

The more southerly roads like Union Pacific, Atchison and Southern Pacific were being bothered by the same unfair competition, but their favorable operating conditions with long hauls and the availability of much traffic, like vegetables and fruits, which require quicker transportation than that furnished by the Canal, made their situation less serious than that of the Northwestern roads.

In the Southwest, the carriers were being assisted by the great oil development, but on the whole there was, and is, too much railway development for the available traffic in that territory. The St. Louis and San Francisco had done comparatively well during the war period and was making a good showing at the time, but its real money making ability is due to its ownership of a line from Birmingham, Alabama, to Kansas City rather than to its position in the Southwest.

In the Southern District there had been noticeable for some time great industrial development. The availability of labor and cheap water power was bringing many mills nearer their source of raw materials. The rate structure was sending much tonnage to Gulf

ports for export, and the rise in cotton prices then current was bringing very much improved economic conditions to the south. Operating conditions were fairly good as to grades, terminals, etc. All this should favor the Illinois Central, the Southern Railway, Atlantic Coast Line, and the Louisville and Nashville. The Seaboard Air Line was too weak financially to be considered at that time.

It was evident that a choice of railroads could be made from the trunk lines, the western roads, the southern roads, and the coalers. In addition, it was worth while to look into Pere Marquette, in the Michigan peninsula, which had made the unique record of earning a profit for the government in both 1918 and 1919; and into the New Orleans, Texas and Mexico, which had begun dividends in 1920 and continued them through 1921, when most roads were contemplating the reverse.

Among the trunk lines, New York Central seemed in the best position. The Pennsylvania and the Baltimore & Ohio were doing well compared to the previous year, but the Pennsylvania was giving signs of overdevelopment comparable in a way to that of the New Haven, and had made enormous terminal expenditures in New York which were perhaps not paying their way. The Central had been able to maintain its dividend and there was every evidence that the dividend would be fully earned in 1921 in spite of the unfavorable conditions. The financial condition of the Erie at that time put its securities out of the question.

The Wabash had some favorable aspects, particularly its ability to move tonnage from the primary markets like Omaha and Kansas City to the east without the delays caused by the congested terminals at Chicago and Toledo.

But the New York, Chicago and St. Louis gave real evidence of good possibilities. For years this line, which parallels the New York Central from Buffalo to Chicago, had been owned by the latter but had not shown much earning ability. In 1916 it had been sold to certain Cleveland interests who were then demonstrating that the line had an earning power never before appreciated. It, of course, had excellent sources of traffic, served a territory rich in resources, had a line with few grades or curves, and had no unprofitable branches. It was moving its cars unusually fast for a trunk line, in that respect being surpassed by only one road in the country, the Union Pacific. It was not surprising, therefore, to find that its earnings were much greater than when the Central owned it; in fact, the earnings, by the Fall of 1921, gave evidence that even though it was a year of depression, the road would have one of its best years. Financially it was in pretty fair shape—not rich, nor yet poor—and it had a well balanced capitalization. Among the trunk lines one was able to choose New York Central as being the strongest and New York, Chicago and St. Louis as having very distinct possibilities.

The roads dependent upon the coal fields for a very large part of their traffic naturally had one definite

hazard, but the probability of better earnings was good. Most of these owned at that time large interests other than in railroads alone, and about these it was always difficult to get accurate and complete information. All were doing much better than in 1920. The Lehigh Valley's earnings seemed less promising than the others, but it was spending very large sums for maintenance of equipment, while most roads were reducing such expenditures. The Delaware and Hudson was doing moderately well as to earnings, but its working capital was not as strong as it might be, and its large investment in street railways in New York State was a questionable asset. The Lackawanna and the Reading were both strong financially and showing fair earnings under the circumstances, and both had what were known to be valuable coal properties which, it was believed, would be distributed to the shareholders at some future date not distant.

Among the bituminous carriers, both Norfolk and Western and Chesapeake and Ohio were making the same progress so general among the railroads, and the latter had been showing marked progress for some years. The former was far stronger financially, but the latter had unusually favorable operating conditions with an outlet (down grade) both to the east at tidewater and to the west at Lake Erie (through the Hocking Valley) and over its own lines into Chicago. Norfolk and Western was the more stable, but the comparatively small common stock issue of the Chesapeake meant that as earnings became larger they

would mount up fast on the common shares. Any one of these coalers, except Delaware and Hudson, could, with logic, be chosen, depending upon the situation of the person making the choice.

If one felt inclined toward an investment in the Northwest in spite of the apparent difficulties; there was the Chicago, Milwaukee and St. Paul, the Great Northern, the Northern Pacific, and the Chicago and North Western. The last named had some time before cut its dividends as a conservative measure. It has the advantage of three lines entering Chicago and is not so burdened with Panama Canal competition as are the transcontinentals. Its earnings in 1921 looked especially bad due to the almost total loss of lumber and ore traffic, but better industrial conditions would probably restore this tonnage to some extent. But this road is heavily burdened with an unprofitable and heavy commutation traffic. The Great Northern also lost heavily in 1921 from lack of ore tonnage on which it is very dependent and which it is particularly fitted to carry at very low cost. It has, besides, a large branch mileage requiring much local service at very small profit, if any. The ore traffic would probably return and with it much better earnings. The Northern Pacific had good diversity of tonnage, good density and probably the strongest financial condition of any of these roads, having an excellent back log against the continuation of bad times in its ownership of the Northwestern Improvement Company. It also still retains its ownership in several million acres of land

grants. In these it had an advantage over the Great Northern which some time before had distributed its ore properties. The St. Paul was immediately eliminated; through August, 1921, it had earned less than \$200,000 net operating income, it was short of equipment, it had not the facilities to gather traffic on the Coast in competition with Northern Pacific and Great Northern, and the traffic on its extension to Puget Sound had not come up to expectations. Further, it had bond maturities of about \$130,000,000 to be met by 1930—a feature which was far from appealing. A choice in the Northwest seemed to be between Northern Pacific with its financial strength and Chicago and North Western with its lower Panama Canal competition, although for some purposes certain bonds of the Great Northern would fill the requirements to be later outlined.

Of the transcontinentals, Southern Pacific, Union Pacific, and Atchison, the last named was the strongest not only financially but in earnings. It was, and still is, probably the strongest railroad in the country. It is ably managed and at the time under consideration (as well as now) was rich in cash resources; its capitalization is beautifully balanced and nearly 40 per cent of its securities are limited to 4 per cent return, which adds considerably to the value of the junior shares; and it was earning at a rate in excess of all its interest and dividend requirements.

The Union Pacific was a close second to Atchison. It is blessed with extremely favorable operating con-

ditions which bring low costs, is well built, efficiently managed, and possesses a fund of over \$200,000,000 in cash assets or securities of reasonable marketability from which it receives a large income. Like Atchison, it was probable that it would earn its dividends in spite of 1921 difficulties.

The Southern Pacific is also a good road, thoroughly well entrenched on the Pacific Coast where it has much local business as well as long haul traffic on its two arms to the East; it is also well managed and favorably situated as to working capital. But in 1921 its heavy investment in Mexico and in public utilities in California prevented it from showing the strength of Atchison or Union Pacific, either or both of which could be chosen as sound companies in which to invest.

The Southwestern roads were eliminated, with the exception noted of New Orleans, Texas and Mexico, which had demonstrated by its earnings and dividend payments that it was individually worthy of detailed study. The road skirts the Gulf of Mexico from New Orleans to the Mexican border at Brownsville. It had formerly been a part of the St. Louis and San Francisco System, but was given over to the bondholders in the reorganization of that line. Its property had been in very bad shape in 1916 and it was considered a hopeless case. Its reorganization, however, was drastic, and provided funds with which the property could be rehabilitated. So successfully had this been done that under its new and good management the road developed a real earning power. The dividend,

therefore, was fairly conservative and likely to be earned almost in full in 1921. Since its securities were little known and unappreciated, they yielded returns far greater than was justified by its earning power and future prospects.

Finally there were the Southern carriers. Of these, the Illinois Central, with its low grade line from Chicago to New Orleans, is favored with good traffic and excellent operating conditions. It was (and is) managed with great ability and in 1921 was getting its expenses well in hand; its earnings were making a favorable showing. Furthermore, its terminal situation in Chicago is an element of great strength, and its line to Omaha a valuable piece of road.

The Atlantic Coast Line and the Louisville and Nashville are really one system, the latter being under control of the former with connections between them in Florida and at Montgomery and Atlanta. In many ways the two are much alike; both are good earners and both serve territory not fully developed. But each has a different character of traffic and dissimilar operating conditions; the Atlantic Coast Line is a low cost road carrying a light density of high revenue freight under the easy conditions of low grades and few curves, while the Louisville and Nashville is an expensive road which, because of its great coal development, carries a heavy tonnage of low revenue freight to be hauled over rather severe grades and frequent curves. Neither was making a particularly good showing in 1921, especially the Louisville and Nash-

ville, which was spending comparatively large sums on its equipment. An interest in the Atlantic Coast Line really includes an interest in the Louisville and Nashville so that the former has an advantage over the latter, but both were strong roads which should profit by the improved conditions in the South.

So too in the case of the Southern Railway which spreads like a net over the whole territory. Except for a large short-dated debt, it had for some time given every indication of being a coming road. Industries had been growing along its lines and the development of the South generally had been faster than for the country as a whole. And the road itself was a much better railroad than for some time; the line from Washington to Atlanta had been double-tracked, unprofitable branches eliminated as far as possible, curves straightened, and grades reduced. Its lines from Cincinnati to New Orleans (the Queen and Crescent Route) had become one of the heaviest traffic lines in the country. There was work still to be done, but the Southern Railway had the earmarks of a road with a distinctly bright future.

Pere Marquette was mentioned because it had made the unusual record of earning a profit under both years of government operations. Very like the New Orleans, Texas and Mexico, it had comparatively recently emerged from a drastic reorganization. The country it served had become unusually prosperous through the development of the automobile and the enormous growth of that industry. In other words, there were

definite reasons why this road's earning statement should make a pretty picture compared to its recent past, and good reason to believe the progress made was of a permanent character. Like the "Gulf Coast Lines," its securities were selling to yield returns which, under the circumstances, were greater than was warranted by the risks involved.

So much for the railroads. The public utilities, too, provided a large field for investments which could be spread all over the country. For the purposes of this discussion it is desirable to treat only those companies whose names are generally known either because of their size or because they are listed on the New York Stock Exchange. Among hydro-electrics, the outstanding ones are probably the Niagara Falls Power, Shawinigan Water & Power Co. (in Canada), Montana Power, Southern California Edison, and Pacific Gas and Electric. While some of these are dependent in part upon steam, the large proportion of their output derived from water power had shielded them from the rise in costs during 1920 and earlier years, thereby sustaining their earnings, and such fall in costs as was in progress in 1921 would nevertheless be beneficial to them.

Prominent companies wholly reliant on coal for fuel were the Brooklyn Union Gas, the Consolidated Gas, the Brooklyn Edison, all in the New York district; the Public Service Corporation of New Jersey, the Edison Electric Illuminating Co., of Boston; the Peoples Gas, Light and Coke and the Commonwealth

Edison, of Chicago; the Detroit Edison; and the Cleveland Electric Illuminating Company. All of these could expect greater gross revenues and probably a cut in expenses which would be substantial. The New York companies were unfavorably affected by politics, but if the Supreme Court should uphold their contention as to the confiscatory nature of gas rates their situation would then be immensely changed for the better. Conservatism, however, pointed to the electric companies of Boston, Chicago, Cleveland and Detroit, the Detroit Edison Company being so well managed that nearby towns were requesting the company to take over municipal plants and run them.

There were two others, however, which, like the little known railroads mentioned earlier, had interesting possibilities, the American Water Works and Electric Company and the Columbia Gas and Electric Company. The former had been formed some years before purely to liquidate certain properties held by Pittsburgh interests who had gotten into trouble. It is the owner of a number of water companies serving a large combined population and controls as well a number of power companies through its ownership of the West Penn Traction and Water Power Co. (now the West Penn Co.). For the year ending June 30, 1921, after full allowance for depreciation, it had earned its interest, first preferred dividends and something on the second preferred. If it could do this during such a time and continue to pay the first preferred dividends as it had been doing for seven years,

it was evident that better business for utilities gave its securities unusual speculative possibilities.

The Columbia Gas and Electric Company had much the same features. Being dependent upon natural gas rather than coal was, of course, favorable. It had also a large electrical business in the growing Cincinnati territory. What was impressive, however, was the fact that in spite of the rising costs of the period from 1913 to 1920 the company had increased its surplus after fixed charges from \$219,446 to \$4,839,377. As the source of its natural gas, it owned or controlled over 1,000,000 acres of land in West Virginia and Kentucky, this land having good oil possibilities in addition to its gas output. Both this company and American Water Works and Electric seemed to be on a rising tide, not only due to prospective general conditions, but in and of themselves.

Classed with public utilities are the telephone and telegraph companies. American Telephone and Telegraph was as sound as could be and would profit by the reduction in costs, as would all those of its general type. But it was well known that it would have a steady stream of financing to do, a repressive factor on its securities. Western Union owns cable as well as telegraph lines; the former probably contribute a greater percentage to the net earnings than do the latter. The Mackay Companies control both land lines and cables, but the proportion of the latter is greater than that of Western Union. Unfortunately the earnings statements of Mackay Companies did not give

sufficient information on which to base a sound opinion. (Some months later, in 1922, a bond circular disclosed that its earnings had been extremely good, that it had been paying conservative dividends, and had added considerably to its assets from earnings.) There was also the All-America Cable Co., formerly known as the Central & South American Telegraph Co. This company had had an excellent record of earnings and conservative management; it had constantly added to its assets and had laid away a very substantial amount of marketable securities; and it owned few land lines which sometimes are of questionable earning power. Altogether, the company's common stock, with no senior securities ahead of it, provided the best prospects at that time among companies of its type, although the senior securities of the others would be suitable in their place.

The leading companies making equipment were Baldwin Locomotive and American Locomotive, specializing in motive power; American Car and Foundry and Pressed Steel Car engaged in car building; and Railway Steel Spring and American Steel Foundries covering a wide field of parts and repair work. Of the two locomotive companies, one was impelled to choose American Locomotive even though Baldwin had been a speculative favorite. The former had on the whole operated in the past at a lower ratio of costs to gross; the capitalization of each was approximately the same, but American Locomotive had no bonds; its working capital was not only larger, but included fewer ques-

tionable foreign securities and had a much smaller amount of notes payable; in fact, the ratio of current assets to liabilities in one was about 4 to 1 against not much better than 2 to 1 in Baldwin.

Of the others, American Car and Foundry stood out strikingly. It had conserved the great profits made during the war, and had diversified its business so that it would not be dependent on car building alone. It had added greatly to its financial strength and had put aside a reserve for common stock dividends sufficient to provide 12 per cent for three years. Both American Steel Foundries and Railway Steel Springs were prepared to profit by the anticipated orders for equipment, but Pressed Steel Car was not as strong as might be in working capital. To include American Locomotive and American Car and Foundry in a list would cover the equipment field and include undoubtedly the best two.

Increased building operations, already in evidence, would bring business to the steel companies. Of these, United States Steel Corporation so far surpassed all the others, that, considering the over-expansion of steel capacity, it was useless to go beyond this producer which would probably control pieces through its position as the low-cost manufacturer of steel. It would make money while others might be losing.

Many would profit from an era of building, but two companies very directly connected were the American Radiator Company and the Otis Elevator Company. Both were strong concerns, well fortified with working

capital and having excellent earning possibilities under favorable circumstances. The former had had an unusually good record, and had escaped the severe losses of the depression because its management had been sufficiently foresighted to have anticipated bad times and had prepared for a depression by turning inventories into cash so far as possible. All three of these corporations could well be included in a list from which selections might be made.

General Electric stood out above all manufacturers of electrical equipment. As a conservative well managed industrial with a future, it would be difficult to find its equal anywhere. Its cash assets were enormous. It is known that it lays away very large reserves, but no one seems to know just how large they are. Their size was indicated by the fact that it had spent yearly large sums for patents, but carried them at only \$1, and that over a period of years, it had spent over \$180,000,000 on plants, but carried them at a value of around \$67,000,000. Such conservatism and indicated earning power was hard to match.

Both Westinghouse and Allis-Chalmers had possibilities in view of the anticipated electrical business. Westinghouse was the better company from the investment point of view, Allis-Chalmers from the speculative point of view. The latter makes a large quantity of heavy machinery which means that its profits do not reach net earnings until some time after orders are received. Its comparatively good earnings in 1921 reflected the orders received in 1920. But it had a

very good working capital and had been able to continue dividends during the depression. The very low price of the stock and the high yield seemed to overestimate the risks.

Companies engaged in the manufacture or sale of articles of general consumption would on the whole profit by the increased purchasing power to be brought by better trade. That such concerns would do better was a fair assumption unless there was something in the particular industry or concern which would militate against it. The chain stores had, through the depression, proved their stability and sound foundation. Of these Woolworth was the leader.

The Allied Chemical and Dye Corporation manufactured a wide variety of products of a basic character which would have a more general demand especially from the building trade. This company was conservatively managed, put away large reserves, and had good cash resources. While it was a new concern, it was made up of a number, except the National Aniline and Chemical Company, which had proved their value over a long period of years, and their combination was logically expected to reduce costs and enhance the earning power of the whole.

The tobacco companies had done fairly well in spite of bad times, due probably to the fact that people smoke whether employed or not. The best known were the American Tobacco Company, Liggett and Myers, Lorillard, and, less well known, the R. J. Reynolds Tobacco Company. In comparing these, one was

forced to the conclusion that the last named had the best record and greatest possibilities. This was very striking from the reports covering the year 1921 in which R. J. Reynolds showed substantially increased earnings, and the payment of over \$13,000,000 notes without financing or reducing its working capital unduly. Further, its valuable good will was carried in the balance sheet at less than \$1,500,000 while the others carried amounts varying from more than \$21,000,000 for Lorillard to over \$54,000,000 for American. This seemed to indicate not only greater conservatism, but the probability of greater earnings on the capitalization.

Of the coppers, one was much impressed by the fact that of the largest, only Kennecott, Cerro de Pasco, and Chile had been able to produce at a cost low enough to warrant the continued operation of the mines during 1921, while almost all others were forced to shut down. In view of the general uncertainty in the industry and its dependence upon export trade, there seemed little question that if copper securities were to be included in a list, these three provided the best security as to earning power. And of these, Cerro de Pasco, with its large silver and gold values, was probably the lowest cost copper producer. Of the domestic companies, Utah could almost surely produce most cheaply, but after all, Kennecott owned a large interest in Utah and its securities, therefore, indirectly participated in any profits Utah might make.

At the time under review, an investor in oil company

securities would undoubtedly have limited the risks inherent in this industry by buying only securities of concerns which pretty thoroughly covered the field; that is to say, not only produced, but refined and distributed. The best were, of course, the leading Standard Oil companies. Worthy of consideration also was Royal Dutch, which not only covered the field in the United States, but had diversified its risks all over the world. This concern is excellently managed, the difficulty being, however, to know just what it is earning, for it reports (like the Mackay Companies) only enough dividends received from its subsidiary companies to pay its own dividends.

From the speculative point of view purely, there was at least one oil company, almost entirely a producer of crude, which gave much promise. This was California Petroleum. It had maintained its earning power in spite of depressed business; it had for some years steadily increased its gross and net income; it had during the year received funds from the Government, thereby increasing its cash resources; and had steadily used its earnings to build up the property. Improved conditions in the industry would undoubtedly be reflected in good earnings for California Petroleum.

A number of so-called "specialties" gave great promise. Among these were United Fruit, Electric Storage Battery and Owens Bottle.

The value of diversification was well illustrated in the case of United Fruit. With two of its divisions,

shipping and sugar, doing badly in 1921, it was making enough from its fruit business to counteract these. It had conserved the large profits made during the war, had added substantially to its properties and to its cash resources, had eliminated its bonded debt, and had increased greatly its reserves. In some respects, its stock took on the same conservative character as that of General Electric, though in slightly lesser degree.

Electric Storage Battery's reason for prominence lay in much the same general factors. As the largest manufacturer of storage batteries, while dependent primarily upon the prosperity of the automobile industry, its interests were diversified into the fields of railroads, telephones, radio, submarines, electric light stations, and other industries. It, too, had conserved its earnings and added greatly to plants and working capital. And this company likewise, regardless of the low production of automobiles, was making very good earnings during the depression.

Of much the same general character was Owens Bottle. Its ownership of an automatic machine for bottle making had so reduced the cost of production that it was obtaining a virtual monopoly. It was ably managed, had laid away conservative reserves, and had good cash resources.

Somewhat later than the Fall of 1921, but by the Spring of 1922, it was evident that the outlook for the companies producing sugar and for those manufacturing automobiles was brighter than at first seemed the

case. In analyzing the situation in these two industries it was necessary still to bear in mind that the least risk and greatest possibility of profits lay with the lost cost producers. Among the automobile companies, the securities of the Ford Motor Company not being available, the most promising seemed to be Studebaker and General Motors. Both of these were quantity producers who could sell their cars at prices which gave very good value for the money.

There was another, a producer of trucks only, which had perhaps an even firmer foundation for future expectations. Here again the company made a car which, although high priced, apparently gave the greatest value for the money, and experiments seemed to prove that it had the ability to move tonnage at less cost per ton per mile than others. During the depression, its sales had held up relatively better than the industry as a whole. In fact, in spite of inventory depreciation, it had, in 1921, operated at a profit. Its cash position was very strong, better by far than that of most of the motor companies. Altogether, improvement in the automobile industry should find Mack Trucks well prepared to take advantage of the situation.

Besides finding the low cost sugar producer, there was another problem. This was to find those which had been least harmed by the disastrous effects of the fall in the price of sugar from above 20 cents a pound to below 2 cents. The pooling of the Cuban output for sale by a commission had in effect allowed all others

to sell freely while the Cubans held back and allowed the market to fall away from them. The producers in Porto Rico, and those in Cuba which had previously contracted for the sale of their output were most favorably situated. This gave promise to Central Aguirre and Fajardo, both in Porto Rico, and to United Fruit and Punta Alegre in Cuba, both of which had their refinery outlets. South Porto Rico Sugar Company, which has the tariff advantages of Porto Rico and also a very low cost mill at Santo Domingo (full duty, however), was worthy of consideration as it has a sort of hedge on the matter of the sugar tariff. But the Cuban American, in spite of its disastrous year in 1921, was still the lowest cost producer and had had the resources with which to withstand its losses. So far as future earning power was concerned, it was particularly favored and had, as well, a very excellent management. On the whole, one must be wary of concerns dependent for their prosperity upon tariff protection rather than a firm economic foundation of low costs. For this reason one would watch carefully an investment in Porto Rican sugar producers, and would include at least one Cuban, either Cuban American or Punta Alegre.

There were undoubtedly many other companies which could have been considered during late 1921 and 1922, many perhaps more favorably situated than those which have been reviewed. But there is a limit to the work which can be done along this line and do it well. It is hoped that the foregoing will illustrate

sufficiently the manner and the possibilities of selecting the companies with investment possibilities from the professional point of view—that is, from the viewpoint of the investor.

There is left the selection of the securities.

WHICH SECURITIES?

In selecting the list of securities which shall form the background on which the investment adviser will base his professional service, he will bear in mind that, strictly speaking, a good investment is one which returns more than pure interest plus sufficient in addition to more than compensate for the risk involved. In this connection, it is now possible to be somewhat more up-to-date than was the case during the period which has been under review. Professor Dewing, previously quoted, has made some investigations of great value along this line. It is surprising that more research in securities has not been done by banking houses, and there is a great field unopened which, if investigated, would probably yield much information and data not yet appreciated.

Take the case of bonds. The usual investor probably believes that he could not be more conservative than to limit his holdings to securities declared legal investments for savings banks in New York and Massachusetts. The laws which outline the requirements for such securities have been carefully drawn with a view to limiting savings banks to investments of unquestioned security. Under the guidance of Professor Dewing, a number of his students have made careful calculations comparing the relative merits of different

classes of bonds as the result of experience.¹ One man invested three hypothetical funds of \$100,000 as of January 1, 1901, in 50 bonds of each class; legal, good, and speculative. He closed these out as of January 1, 1923. He calculated his fund by crediting the interest and deducting his losses. There was one default in his list of "legals," two in his list of good bonds, and eleven in his speculative list. Nevertheless, the income in each of the latter cases made up the capital losses, so that his total accumulations from the original \$100,000 investments were respectively \$195,000, \$214,000 and \$246,000. Two other students took 100 bonds in each class as of October 1, 1900, handled them in the same manner, and closed out October, 1922. They found that, after deducting losses, the average yields over the twenty-two year period in each case were respectively 3.03 per cent for legals, 3.99 per cent for medium grade, and 5.50 per cent for speculative bonds. Another took the actual railroad investments of certain Boston savings banks, bought between 1892 and 1902, and compared them as of January 1, 1902, with 87 high to middle grade railroad bonds yielding between $4\frac{3}{4}$ per cent and $5\frac{1}{4}$ per cent. Treating them in the same manner as in the other two investigations, he found that the legals had accumulated \$182,275 at an average annual return of 3.17 per cent, while the others had accumulated \$246,743 at a return of 4.62 per cent.

It is, therefore, clear that the artificial demand set

¹ See footnote page 459, Harvard Business Review, Vol. I, No. 4.

up for bonds of the "legal" class has carried their prices to the point where the return obtainable underrates the risk involved. An individual in his investments will, as a result, shy away from such bonds, and will look for a return more commensurate with the chances he takes.

Much the same thing is true of preferred stocks, especially industrial preferred stocks. Referring again to Professor Dewing's investigations,² he compiled a list of all the prominent industrial preferred stocks issued between January 1, 1915, and January 1, 1923. There were 607 of these which were issued at an average price of 99. After crediting the premiums on such issues as were called, the average price for the group as a whole was (on January 1, 1923) 70½; and of the 607 issues, 114 were quoted at less than 25, and of these, 59 were practically worthless; and for 70 issues, no quotations, even nominal, could be obtained. Obviously, industrial preferred stocks, unless exceptionally strong, underrate the risk very substantially.

Preferred stocks have the great fault that their priority claim on assets is not fixed. Bonds, debentures, and bank loans can always be placed ahead of these issues with consequent depletion of their claim on the equity in the concern. Furthermore, where the income return is fixed, the holder has not the advantage of a possible increase in income to make up for his possible loss of principal. These stocks are hybrids; they are neither bonds nor common stocks; they have

²See page 461, *Harvard Business Review*, Vol. I, No. 4.

all the possible losses of the latter without the advantages of either.

Purchases of preferred stocks would, therefore, better be definitely limited to those of companies whose earning power is so substantial and regular that they partake very much of the nature of bonds; to those that participate with the common; or to those of companies which are definitely on the upgrade and whose preferred shares are selling at prices which, under the circumstances, seem to overestimate the risk. In the first class the preferred shares of Union Pacific, Atchison, and others like them, and some of the preferreds of higher grade public utilities.³ Among the industrials few can qualify beyond those of United States Steel, General Electric, and Standard Oil of New Jersey. In the second class, there are a number of merit, and the third class is made up of those which can be discovered from time to time, depending upon the conditions then prevailing. Of course, in a period like that of 1921, there are usually many which, because of shaken confidence, sell well below the price which would more accurately measure the risks a purchaser would incur. A good general policy is to buy bonds whose place in the capitalization is fixed, common stocks carefully investigated, or preferred stocks which have the advan-

³ During the year 1923, there have been a number of Supreme Court decisions which seem to assure to public utility companies the ability to earn a definite and reasonable return on their properties. In the future, they should have less trouble in raising rates to match expenses. This establishes for them the expectation of a very stable earning power and gives public utility preferred stocks a much higher credit rating than they have enjoyed in the past.

tage of either one or the other; that is, great stability of earning power or speculative possibilities.

With these things in mind, and remembering that the companies so far selected are those which seem to have the least risk, it is possible to go back over the list of corporations, to scan their securities, and to make up a broad list from which choices may be made in accordance with the requirements of the particular investor's situation. Incidentally, for the purpose of being thoroughly clear, only the active securities will be discussed.

New York Central—In the main its bonds are "legal." It is possible to find among its subsidiaries some which are not. For example, Cleveland, Cincinnati, Chicago & St. Louis 4s of 1993, a good long-time bond which should fill the bill. The parent company's debenture 6s, 1935, although not mortgage bonds, have not only good security as to earning power, but some speculative possibilities as well, due to the ability to convert into New York Central common stock. And the latter would provide very fair chances of appreciation with reasonable security.

New York, Chicago & St. Louis—The first mortgage 4s of 1937, and the debenture 4s of 1931 were good, and yielded a fairly high return. The preferreds, both first and second, were participating stocks and had an excellent combination of security and speculative possibilities. The common had less security, but, because of its then current earnings, great possibilities.

Delaware and Lackawanna—Only the stock was

available, but should have been purchased only by those who could get the necessary information on the coal properties.

Reading Company—The bonds in the main are “legals,” which are eliminated. The stock was in the same situation as that of Lackawanna.

Norfolk & Western—Under the circumstances, most of the bonds being “legal,” the convertible 6s seemed the most attractive. The preferred stock in this case is strong enough to warrant consideration. The common stock should do better under favorable conditions.

Chesapeake & Ohio—There were again available convertible bonds, 5s due 1946, which had a favorable outlook, and the General 4½s of 1992 were attractive as a long-time security in a period of falling interest rates. Again, the stock would be suitable for certain investors.

Union Pacific, Atchison, Illinois Central, Louisville and Nashville, and Atlantic Coast Line—Practically all of the bonds of these roads were too high grade for the ordinary investor, being “legal.” The preferred stocks of the first named two, and the Leased Line Stock of the Illinois Central were sufficiently protected by stable earning power to be considered sound. The common stocks of all had good possibilities.

Great Northern, Chicago and North Western and Northern Pacific—If one wished to invest in a north-western railroad, the general mortgage 7s of the former best fitted the general scheme, but only the preferred stock of the North Western (which participates with

the common), or the common stock of the Northern Pacific did so.

Southern Railway—Nearly any of its bonds were ideal for the investor, not being "legal," and yet distinctly on the upgrade. The two stocks were speculative, yet attractively so.

Pere Marquette—The underlying bonds fitted in the same manner as did those of the Southern Railway. The two preferred stocks seemed to underestimate rather than overestimate the risk, and the common was distinctly speculative.

New Orleans, Texas and Mexico—The first 6s of 1925 were very high grade and far underestimated the risk. So, too, the second mortgage income 5s which had paid interest since the reorganization. The common yielded over 10 per cent, and could be said also to return more than the risk called for.

St. Louis & San Francisco—Since its good earnings came from the line, Birmingham to St. Louis, the bonds on this line, not being "legal," had distinct possibilities, especially because the strength of the issue was not generally appreciated. For these reasons the Kansas City, Fort Scott and Memphis Refunding 4s of 1936 could be included in the list.

Public Utilities—Many bonds suitable to the purposes of the individual investor could be found among the public utilities. Some were in the "legal" class, but others, not the most senior issues, yielded returns which were attractive. It is not necessary to cover the field in detail, so only a few examples will suffice.

The refunding mortgages of the Niagara Falls Power Company, Shawinigan Water & Power Co., Southern California Edison, and perhaps less strongly, the Montana Power Co., stood out in the fields of hydro-electric companies, and the returns obtainable were very good. In like manner, the more junior mortgages of the Detroit Edison, New York Gas, Electric Light, Heat and Power Co., Brooklyn Edison, Cleveland Electric Illuminating Co., and Commonwealth Edison filled the bill. The Niagara Falls Power has such stability of earning power that its preferred stock could be included. The most attractive common stocks were those of the Detroit Edison, the Pacific Gas and Electric, the Edison Electric Illuminating Co. of Boston, and, from the speculative point of view, the preferred stocks of the American Water Works and Electric Company and the common shares of the Columbia Gas and Electric Company, both of which have already been discussed in some detail. The common stock of the North American Company, which owns the equities in a number of prominent public utilities, was one with good possibilities in fair weather, but it is one which should be carefully watched, for in bad weather, equities in earnings might disappear rather rapidly.

The American Telephone and Telegraph securities were undoubtedly good, even though they would be under the constant pressure of new financing, and many of the bonds of the subsidiaries would suit the purposes of the investor. Among the stocks of telegraph and cable companies, that of the All-American

Cables seemed to have the greatest possibilities, although later that of the Mackay Companies assumed the leading position.

Of the industrials which have been selected, the securities available were almost entirely common stocks, namely, those of American Locomotive, American Car and Foundry, American Radiator, Otis Elevator, General Electric, Woolworth, Allied Chemical and Dye, R. J. Reynolds Tobacco, Standard Oils, Royal Dutch, Electric Storage Battery, Owens Bottle, United Fruit and United States Steel. In the same class could be put the preferred stocks of Allied Chemical and Dye and of Allis-Chalmers, both of which were selling at prices which underestimated the risks in their purchase. More speculative in nature were the common stocks of California Petroleum, Cerro de Pasco, Kennecott and Chile. Later were included the preferred and common stocks of General Motors; the common and preferred stocks of Mack Trucks (the preferreds both sold very low considering the better conditions); the common and preferred of Cuban American Sugar, and the common stocks of Studebaker and Punta Allegre.

Industrial bonds which fitted into the scheme through the proper combination of security and yield were difficult to find, particularly because the companies whose outlook seemed brightest were on the whole so conservatively managed that few of them had any bonded debt. United States Steel sinking fund 5s and General Electric debenture 5s, 1952, would do because of their unusual security. Cerro de Pasco

convertible 8s, due 1931, seemed to have an unusual combination of security, high yield, and possibilities of profit. The Cuban American 8s of 1931 yielded enough to more than compensate for the risk. The Western Electric 7s, due in 1925, were satisfactory except for the short maturity, but they could be converted into a preferred stock which would have strength. There were available any number of bonds of mining and oil companies, but, as a general proposition, the risks inherent in these industries make it advisable to be in a position to participate in the profits rather than to lend them money. Of course, the earning possibilities of Kennecott, Standard Oil of New York, and Standard Oil of California gave their bonds excellent security, but the same applied to their stocks with far greater chances of increased income and profits to make up for such chances as might be taken. One trouble with most of these high interest-bearing industrial bonds was that most of them were callable. This put a limit on the rise which they would make under favorable money conditions.

Finally, there were the foreign bonds. Of these, those of France, and Great Britain seemed to give the best combination of security and return. The French Republic 7½s had the merit of being non-callable until maturity in 1941; there would unquestionably be periods of nervousness in the meantime, but the probability of payment in full with interest when due was sufficiently great to make the then current yield attractive. Even more attractive were the United

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Kingdom of Great Britain and Ireland 5½s, due 1929, which were (and are) convertible on such a basis into English National War bonds that they had not only security and good return, but also a speculative feature.

It is now possible to compile the list in full as follows:

INVESTMENT BONDS

Railroad

New York Central Debenture 6s, 1935
Cleveland, Cincinnati, Chicago & St. Louis General 4s, 1993
New York, Chicago & St. Louis First 4s, 1934; Debenture 4s, 1931
Norfolk & Western Convertible 6s, 1929
Chesapeake & Ohio General 4½s, 1992; Convertible 5s, 1946
Great Northern 7s, 1936
Southern Railway First 5s, 1994; Development & General 4s, 1956
Pere Marquette First 5s, 1956
New Orleans, Texas & Mexico First 6s, 1925
Kansas City, Fort Scott & Memphis Refunding 4s, 1936

Public Utilities

Southern California Edison General & Refunding 6s, 1944
Shawinigan Water Power 1st Refunding 5½s, 1950
Detroit Edison First & Refunding 6s, 1940; Convertible Debenture 8s, 1931
New York Gas & Electric Light, Heat & Power Refunding 4s, 1949
Brooklyn Edison 7s, 1950
Cleveland Electric Illuminating Co. 1st 5s, 1939
Commonwealth Edison 1st 5s, 1943
Montana Power Co. 1st & Ref. 5s, 1943

Industrial

General Electric Debenture 5s, 1952
Cerro de Pasco Convertible 8s, 1931
United States Steel Sinking Fund 5s, 1963
Cuban American Sugar 8s, 1931
Standard Oil of New York 7s, 1931
Standard Oil of California Debenture 7s, 1931
Western Electric 7s, 1925

Foreign

Republic of France 7½s, 1941

Kingdom of Great Britain & Ireland 5½s, 1929

INVESTMENT STOCKS*Railroad*

Norfolk & Western Preferred

Norfolk & Western Common

Union Pacific Preferred

Union Pacific Common

Atchison Preferred

Atchison Common

Illinois Central Leased Line Stock

Illinois Central Common Stock

Public Utilities

Niagara Falls Power Co. Preferred

Detroit Edison Common

Brooklyn Edison Common

Edison Electric Illuminating of Boston Common

All-America Cables Common

Industrial

General Electric Common

Allied Chemical & Dye Preferred

Woolworth Common

Standard Oil of New Jersey Common

Standard Oil of New York Common

Standard Oil of California Common

Standard Oil of Kentucky Common

Royal Dutch Common

Electric Storage Battery Common

Owens Bottle Common

American Locomotive Common

American Car & Foundry Common

American Radiator Common

United Fruit Common

United States Steel Common

Otis Elevator Common

General Motors Debentures

SEMI-INVESTMENT BONDS

New Orleans, Texas & Mexico Income 5s, 1935

SEMI-INVESTMENT STOCKS

Railroad

New York, Chicago & St. Louis First Preferred
 New York Central Common
 Louisville & Nashville Common
 Atlantic Coast Line Common
 Chicago & North Western Preferred
 Pere Marquette Prior Preferred

Public Utilities

Pacific Gas & Electric Common
 Consolidated Gas of New York (after the Supreme Court decision)
 American Water Works 7% Preferred
 Columbia Gas & Electric Common

Industrials

Allied Chemical & Dye Common
 R. J. Reynolds Tobacco Common
 Allis-Chalmers Preferred
 Cuban American Sugar Preferred
 California Petroleum Preferred (Participating)
 Mack Truck First Preferred

SPECULATIVE STOCKS

Railroads

New York, Chicago & St. Louis Common
 Chesapeake & Ohio Common
 Northern Pacific Common
 Southern Railway Preferred and Common
 Pere Marquette Preferred and Common
 New Orleans, Texas & Mexico Common

Public Utilities

American Water Works & Electric Participating Preferred and Common

Industrial

Allis-Chalmers Common
 California Petroleum Common
 Cerro de Pasco Common
 Kennecott Copper Common

Chile Copper Common
General Motors Common
Studebaker Common
Cuban American Sugar Common
Punta Allegre Common
Mack Trucks Preferred and Common

The list includes 30 investment bonds consisting of 13 railroads, 7 public utility, 7 industrial and 2 foreign bonds; 29 investment stocks, 8 railroad, 5 public utility, and 16 industrial; 17 semi-investment issues, 1 bond, 6 railroad stocks, 4 public utility stocks, and 5 industrial stocks; and 21 speculative stocks, 8 railroads, 2 public utility and 11 industrial. It will be found to represent every division of the country, except New England, among the railroads, to cover every division except the Southwest by some representative public utility, and to cover nearly all parts of the United States, as well as many foreign countries, through the list of industrials. There is one public utility in Canada; a copper company in Peru, two in Chile (one through Kennecott, which owns Braden), and one in Alaska; a bond of France and one of England; two companies in Cuba; one concern covering a large part of Mexico, Central America and South America (All-America Cables), and the whole world as the field of the Standard Oils, Royal Dutch, and some of the other industrials. Certainly, it seems possible to obtain adequate diversification as to type and geographical location.

It is not meant to convey the impression that the foregoing list is perfect or that it cannot be substan-

tially improved upon. What it is designed to show is how a list could have been scientifically made up in the light of conditions which were definitely foreseen in the Fall of 1921, combined with the knowledge since obtained on relative security values as the result of Professor Dewing's investigations in "legal" bonds and preferred stocks which are the only classes which have been changed to any extent. There are many other securities which might better fit the purpose in mind, but it is quite impossible to cover the whole security field and do it adequately.

It will be said that the time chosen as an example was an unusual one. This is true. But being unusual it serves better to illustrate the principles which it is firmly believed are applicable at any given time. It serves as a starter from which one can proceed to add to or take away from the list those securities which changing conditions point out.

It may be of interest to follow the list through the following two years.

THE PROCEDURE

A list has now been prepared from which can be chosen those securities which fit the requirements of any particular investor, except those who, because of the size of their incomes, will need tax-exempt bonds. Since they can turn to specialists in this type of securities they have not here been discussed.

For others, there will be chosen a back log of bonds. But it will be borne in mind that the underlying factor in the situation is the excessive gold supply which may cause inflation. Each investor will, therefore, be advised to hold some common stocks, or participating preferred stocks, in order to provide against such a contingency with securities which will (by larger income return or by profits) make up in part for the expected rise in the cost of living. Since rising prices would favor the industrials more than other classes, which would, in fact, be hurt if prices rose very far, a larger proportion of the stocks of this type should be held.

In 1921, falling interest rates were apparent sometime before the Fall. As early as May, deposits had begun to flow into the banks, loans to be paid off, and interest rates to fall. The banks had no use for the money in business, and at the time would probably not have lent it if they had, so their only place for it was

in the bond market. From this time on bonds could be bought with every expectation of rising prices, and the longer time the bond had to run the better.

By the end of August the underlying factors looked better. Not only were money rates still falling, but building was increasing, and the rise in the price of cotton was having a very favorable influence on sentiment. By the end of September, stock prices had been rising for over a month, and largely confirmed the view that the turn in the stock market had come. The investor could begin to add the better grade of stocks to his list, particularly those whose dividends were so secure that they would not only be favored by the prospects of better business, but also by falling interest rates.

Gradually the situation improved. By February the consumption of sugar had so increased that securities of sugar producing companies could be added to the list. Very shortly thereafter the large orders for automobiles became known, together with the fact that motor manufacturers were very rapidly turning their excessive inventories into cash and paying off their very large loans. So the best securities of these companies, and of those which made automobile accessories, were put on the list. From time to time others could have been added.

By the middle of the summer the volume of business had increased to the point where it could be expected to have an influence on the available supply of money. Interest rates must be watched. It was

possible that the Fall demand for funds would bring higher rates. In September it was evident that the low point for money had been reached in August. In an investigation made months before, Col. Ayres had discovered that in every cycle since 1883 the peak of the bond market had come exactly fourteen months after the low point of pig iron production. This also pointed to September as the top of the bond market. By October, the Harvard Economic Service announced that money rates, adjusted for seasonal variation, had risen to the point which usually marked the end of a rising bond market. It was evidently time to sell long time bonds and to conserve the capital at use in this type of security by buying instead short-time securities. Since one cannot anticipate when the money will be needed again, it is proper to buy only those with the most active market. U. S. Government Certificates or Treasury Notes best serve the purpose.

The list of stocks by this time needed some revamping, for some were too high. This was strikingly true of Allied Chemical and Dye, which had risen to a point which discounted a \$6 dividend. Since this was the most that could be expected, and since it was far from sure, it was evidently time to get out of this stock, at least temporarily.

But money had not yet risen sufficiently to bring fear about the stock market in general. Through the Winter months and the opening months of 1923, however, the rapidly rising commodity prices and the upward trend of wages did lead to the belief that money

would come into sufficient demand to be taken away from the stock market. And in March, the Harvard Service announced that commercial paper rates had reached the point which usually marked the end of the rise of stock prices, but they pointed out that the beginning of the fall in prices had, on one occasion in the past, been delayed as long as twelve months. The market might be at the peak, but not necessarily at the beginning of a decline. In any case, it was time to begin to consider getting out of stocks and especially of those which, the reverse of 1921, would be unfavorably affected by rising interest rates. It was also evident that the over-production of oil was taking on serious proportions.

At this time began an unusual sequence of events. The stock market, business activity, commodity prices, and money rates all began to fall together. It is especially noteworthy that prices and money declined simultaneously, for falling commodity prices usually "freeze" loans and bring higher rates. It was known that there had been many warnings against inflation, both the personnel of the Federal Reserve Banks and of leading New York banks were afraid of it. There was shaken confidence due to the rapidly rising wages and the strikes in the building trades. But while some industries, like pig iron, had gone too far, there was no serious over-production; in fact, inventories were low and buying had been largely from hand-to-mouth. The underlying factors of large gold supply and easy credit still predominated, and to date this country has

always made full use of its credit resources. It seemed a logical conclusion, therefore, that the reversal in the trend of events was psychological rather than economic, and that the holder of stocks should patiently await the resumption of the normal trend.

This view of the situation was confirmed in part by a study made by Prof. Persons, who pointed out that in only one previous year had this country seen a similar combination of falling commodity prices and falling money rates. This was in 1900, in which was seen the same lack of confidence in the future as was witnessed in 1923, and that year was followed by nearly two of good business.

In describing the analysis of general conditions, it was pointed out that the drawing of conclusions from past economic experience cannot be infallible. It can only show what has usually been the case and point to the *probabilities* in the future. In this case, the probability seems to be that active business will continue, just as the probability late in 1921 was that business would be better. But only the future can prove whether this is a correct conclusion.

The list is, therefore, left holding U. S. Government short-time securities and common stocks. Should inflation make progress, one will have to watch its effects on railroad and public utility costs, and it may become necessary to switch from these to more industrials, perhaps those producing raw materials. If, on the other hand, the use of money in fixed capital, like buildings, or in the purchase of foreign securities, de-

pletes the credit resources before there is inflation, the time may arrive to hold nothing whatever but Government notes.

Watch the trend of economic events!

Many people will find that the procedure outlined above, namely, that of frequently switching from one type of security to another, goes against the grain. They buy securities to hold them. Others will say it takes too much trouble. It does take trouble, but it pays. To keep one's securities in a state of flux does two things of definite value. It conserves profits and cuts short losses. The first is self-evident, the second not so evident. The cutting of losses comes first from the fact that the securities are sold at the apparent top of the market as a whole regardless of the prices of the individual securities. Secondly, when the business trend is reversed no one knows exactly where the lightning will strike, and the investor can from a distance watch them all with an unprejudiced, broad-visioned eye. Finally, when he buys again, he buys the best at that time; it may be what he held before, and it may not be. In brief, he holds, so far as possible, the best at all times, while the man who buys and holds forever has something which was probably good when he bought it, but its value may change rapidly with conditions and be a very poor buy a few years later.

Of course, to keep a list of securities in a state of flux takes trouble, but this is another reason to enlist the services of the expert.

It will be asked, how does such an investor contribute funds to industry? He can do so directly by buying bonds of new issues until he is convinced that the bond market has turned downward. From then on he can buy government notes or stocks. But in each case he will carefully compare the new offerings with the seasoned issues available to be sure that he has been offered a fair bargain and that the return on the security is fully up to the risk he takes, bearing in mind the added risk of unseasoned bonds and stocks. The investor will contribute indirectly to financing industry by buying seasoned securities when he has funds available, thereby releasing money for the use of those who may be in a position to take more risk than he can. For instance, the business of some companies is of such a nature that their securities should be owned only by those managing their affairs. If they need money, the ordinary investor stands ready to buy such other securities as members of the management may have, thereby releasing to them money for this business.

The procedure here outlined does not deprive industry of the funds necessary to expansion, but it helps to assure that the new securities will be offered on fair terms and at fair prices to those who are expected to provide the money.

SPECULATION

To include a chapter on speculation in a book devoted to investment as a profession may seem to tend to the paradoxical. There are several reasons for doing so. Speculation, the word, is not fully understood and in its common usage is rather generally considered as synonymous with gambling. This is a mistake, for speculation in its proper form is the stabilizer of our markets and a powerful influence toward the stabilization of business. Another reason for discussing the subject is that the desire for quickly acquired riches is so thoroughly imbued in the vast majority that the general public has been the prey of the unscrupulous who have played upon ignorance and catered to the speculative instinct. To picture speculation as it properly should be engaged in may lead partially to some curtailment of speculative desires and in any case, it is hoped, to their direction into the channel where they will be used to the nation's best advantage—the stabilization of the markets. Finally, previous chapters have spoken of "speculative possibilities." It is desired to point out more exactly the meaning in which the word is used.

After all, investment itself, if properly accomplished, is speculation in some degree, the degree varying inversely with the study which has been made of the

subject before the security is purchased (or sold), and directly with the risks assumed. In a business sense the word speculation means to discern, to perceive, and to act upon what is foreseen. The essence of speculation is the use of foresight, and the risks inherent in speculating are the direct result of the fact that foresight cannot be infallible. Sound investing requires foresight to the ultimate degree, and to this extent is speculation. The latter crosses the line into the sphere of gambling when there has been no detailed study on which a forecast can be made or when unexpected contingencies have not been reasonably provided for so far as possible. The man who bought Liberty bonds at 93 late in 1919 on the snap judgment that they could go no lower because they were obligations of the financially strongest nation in the world, and would give him a quick profit, failed to study his subject deeply. He was gambling. But the man who had considered every fact, including the trend of money rates, and who sold his Liberty bonds was speculating. Speculation differs from gambling principally in that it is a transaction engaged in after careful study and the consideration of all the relevant facts, while the latter is distinctly a shot in the dark regardless of the instrument which forms the basis of the transaction.

The Governor's Committee on Speculation in Securities and Commodities, a political body, supported these views when, in 1909, after a complete investigation, it reported to the then Governor, Charles E. Hughes,

among other things that: "In law, speculation becomes gambling when the trading which it involves does not lead, and is not intended to lead, to the actual passing from hand to hand of the property that is dealt in. . . . A real distinction exists between speculation which is carried on by persons of means and experience, and based on an intelligent forecast, and that which is carried on by persons without these qualifications. The former is closely connected with regular business. While not unaccompanied by waste and loss, this speculation accomplishes an amount of good which offsets much of its cost. The latter does but a small amount of good and an almost incalculable amount of evil. . . ." And also that: "Purchasing securities on margin is as legitimate a transaction as a purchase of any other property in which part payment is deferred."

Some consider that the purchase of securities becomes gambling as soon as it is done on borrowed money. It is true that the use of credit makes possible an increase in the size of the commitment and thereby enlarges both the chances of loss and the chances of profit. If the equity above the sum borrowed is so small that a slight and unexpected turn in the market, even though temporary, can wipe it out, the purchaser of the securities has certainly gambled against an unfavorable turn of events. But the very fact that borrowed money was used does not mark the transaction as gambling. Compare, for instance, the man who buys bonds when money rates are high and probably at the peak, or buys even Atchison, Illinois Central,

or General Electric common stocks and uses other funds than his own to complete the transaction, with another who buys some wild oil stock and pays for it in full. Which of these is the gambler and which the speculator? There is no more reason to criticise the purchase and sale of securities on borrowed money than to criticise the merchant or manufacturer who uses credit for the purchase of his wares or raw materials. Like so many other things, the fault, if there is any, lies not in the doing, but in the manner in which it is done.

Selling "short" no more marks the gambler than does buying on margin, provided the sale is made after the same studious investigation as is a purchase. A profitable speculative operation consists of a purchase and a sale at a higher price, but whether the sale precedes or follows the purchase makes not the slightest difference. It is true that when the sale comes first there is an added element of risk, for there is a limit on how far down a security can go, while there is none on the up side. It is true, also, that in the case of stocks the supply is limited and might be cornered, and that since stock must be borrowed for delivery against the sale, the seller runs the danger of being unexpectedly at the mercy of the lender and perhaps also at a particularly unfavorable moment. But although these facts call for extra care on the part of one who sells what he does not own, strictly speaking, there is little difference between the man who, owning oil stocks in March, 1923, after a careful study of the oil situation

sold his stocks with a view to repurchasing at a lower price, and he, who after the same study came to the same conclusions, sold short, borrowed for delivery, and bought later. The latter took more risk and made more money in proportion to the capital he used, but both tended to stabilize the market by keeping it from going too high and by buying when oil stocks were too low. Both were speculators.

The usefulness of short selling as a market stabilizer is not everywhere appreciated and there have been proposals to forbid the practice. In fact, the economic value of the speculative markets, whether securities or commodities, is so little known that they are in constant danger of governmental interference. Within the year 1923, our high-minded officials have attempted to control speculation in grain because they claimed that it tended to keep the price of wheat down, and have sought to restrict the activities of the New York Coffee and Sugar Exchanges because speculation in sugar had put it up. These exchanges perform two very important functions. First, through the speculative anticipation of a shortage or excess supply of a commodity, the purchases or sales tend to raise or lower the price of futures and to encourage or discourage the production of the commodity before the event. If the price of future sugar tends upward, there is reason to believe that more will be produced, thereby counteracting the prospective shortage, and vice versa. Secondly, these exchanges, through the activity of the many speculative sales and purchases,

provide a market for hedges so that the miller, the sugar refiner, or the cotton manufacturer may hedge and reduce his risks, as may also the producer of the commodity. The risk is passed to the speculator who, in return for prospective commensurate profits, assumes it. Short selling in these markets is consequently the expression of studied opinion as much as is buying, and both are equally necessary.

The same is more or less true of the security markets. The selling, whether of short or long stock, acts as a pressure on the market to restrain over-optimistic enthusiasm, and the repurchasing acts as a cushion for a market which, in a time of panic, would have no bottom. Germany and Japan have both tried to forbid short selling, but both discovered it was a mistake for the reason that during a panic in the market, when many are in a position where they must realize on securities, there are no buyers. Such a market is the opportunity of the short seller, and by buying at such a time he furnishes a real service. After all, the contractor who engages to erect a building has sold that building short; he knows pretty well from experience that he can "cover" his materials and labor and usually makes his contracts as soon as possible to obviate the risk of rising markets; but he may run into a strike which would cause him to take a loss. So short selling of stocks and bonds does not mark the gambler and is usually the operation of one who has thoroughly studied the situation. Such a man is a speculator and a useful stabilizer to the market.

As has been said, investment involves the application of speculation—the study and investigation necessary to as true a forecast as is possible. The assumption of risk is inherent in any investment; the greater the risk, the greater the tendency for investment to degenerate through speculation into gambling. Anything which minimizes the risk increases the safety of the investment. Whatever, therefore, is of value to reduce the risk of speculation has some lesson for investing. The following are some primary rules for one who insists on speculating and would eliminate gambling; the investor may derive some profit therefrom.

In previous chapters has been outlined the methods which seem best suited to the analysis of conditions so that purchases and sales of securities may be made at the proper time and with some prospect of appreciation. Such methods are even more desirable to the real speculator. These include the detailed economic study of general conditions and of those in the various industries. There is naturally, too, the careful study of the corporations. It is further desirable, in order to reduce the risk, to have good diversification. If possible, and it is difficult to do so, it is valuable to have some knowledge of the technical market conditions, especially if it is planned to speculate in some one particular security. On the whole, while at any given time the market price of a security may not be representative of its value, in the long run value will be the final determination of price. Successful speculation is consequently concerned with the determina-

tion of future values and is particularly interested in the time at which a security is bought. These factors, it may be repeated, are of importance whether the security is paid for in full, partly in borrowed money, or sold short.

If borrowed money is to be used, or if the selling is to precede the buying, there arises the question of margin. It should be large enough so that short and temporary reversals will not jeopardize the whole transaction. It is unfortunately true that many men have done all the work necessary to assure themselves success in some speculative commitment, but by being a little over-greedy and by an over-dependence on other money than their own they have failed to cash in. They skated too close to the thin ice of gambling. There is another point about small margins. If a broker will consent to a margin which is obviously unconservative, he throws into danger the equities of all his customers; for he may have dealing through him some plunger who will get into trouble, eat into the capital of the firm, and perhaps drive it into receivership. If a firm will accept a small margin from one customer, they will do so from another, and each such account endangers the money in the others. By all means, be sure the firm dealt with is conservative and even strict regarding margins. It may be unpleasant to have a firm insist that a good-sized minimum margin be maintained, but really it should be a source of gratification to know that money at risk has not

the added danger of being jeopardized by the foolhardiness of others.

The man who is speculating and not gambling should beware of the broker who urges him to make small turns by going constantly in and out of the market. No one can do much more than guess the small turns and speculating should eliminate as much as can be all guesswork. If a studied opinion does not hold forth the prospect of a substantial profit, the risk is too great to be fully compensated for. It is well to bear in mind that every purchase and sale of one hundred shares of stock costs approximately three-eighths of a point in commissions and taxes. This much must be made before there can be a profit and this amount constitutes the odds against the in-and-out trades. Not only is such trading closely akin to gambling, but it will probably be found that, like the Kelly-pool game, where everybody lost, the only winner was the pool-room which got its commission out of every pot.

In connection with small turns and the odds against their success, there are many attempts to make the market furnish the funds for some specific purpose. The case comes to mind of a young man who was about to make a trip to Cuba and asked a genial customer's man for a suggestion as to how he could entice the market to give up the money to cover his expenses. The proposal was made for the purchase of five hundred shares of a stock in which two points profit should be sure. The gentleman went to Cuba and on his

return took a loss of several thousands in his stock. There is also the classical story supposed to have been told by Mr. Livermore of the office in which a number of men in turn tried to inveigle the market into surrendering the wherewithal for a fur coat which many had admired. It is understood that the coat was never bought—by the traders. One other extreme example of the danger of guessing at small turns. A certain gentleman owned five hundred shares of Middle States Oil in which he had a very substantial loss. This was at a time when losses could be registered in the market and deducted from income tax reports without having to wait thirty days before repurchasing. On the day in question the owner of the stock decided to sell and repurchase at once. It would have been possible for the broker on the Stock Exchange to “get between” another trade, to sell to one man and buy from another, thereby assuring the completion of both sides of the order at one price. But the customer thought he might be able to save his commission and tax costs by selling three-eighths of a point higher than he bought. At the moment the market was strong. He, therefore, gave an order to buy five hundred shares of Middle States Oil and when bought to sell his other five hundred three-eighths of a point higher. He bought his five hundred, making his total holdings one thousand—and before the price went up the required amount it went down approximately ten points. In an attempt to make the market pay his costs amount-

ing to less than two hundred dollars he had lost nearly five thousand in a few hours.

Playing for small profits does not pay, for it is gambling against the odds. No commitment is worth the risk unless a substantial profit is in prospect. The broker who encourages in-and-out trading does very well for himself—but not for his customer.

Another general rule of importance to the speculator, and of real value to the investor, is “to cut the losses short and to let the profits run.” As pointed out on an earlier page, it is extremely difficult to come to a decision to take a loss, particularly if it is a small one; there is always the hope that the price will turn up again. There are many, too, who believe that “taking a profit (even small) never hurt anyone.” The result is that many take small profits and let the losses run. Such people usually resort to averaging as the method of pulling themselves out of the hole. This is equally bad. So far as the speculator is concerned, if after a careful study of a situation he has made a commitment and the market has gone against him, it is *prima facie* evidence that something has been overlooked and that he is wrong. He should get out then and there; averaging only doubles up a speculation which has proved itself bad. In getting out he has saved his resources for another attempt which perhaps will be more of a success. If, on the other hand, the market goes with him, this is good evidence that his conclusions were correctly drawn; then is the time to double

up.¹ The application of this rule to the investor will take a slightly different form. His purchases of stocks will naturally be of the high grade variety and he will pay no attention to the minor market fluctuations. He should, however, sell at once regardless of price if something unexpected or overlooked shows the purchase should not originally have been made, or the situation has substantially changed. And there should be no reason for him to average, for he is following a definite plan which does not call for such action and should avoid the necessity.

Another means of reducing the risks of speculation which has not had the recognition to which it is entitled is the use of puts and calls. A put is an option to deliver (sell) a specified amount of stock at a stated price within a given time. A call is an option to purchase a specified amount of stock at a stated price within a given time. Although here are variations in price, these options are usually given for thirty days for \$137.50 a hundred shares plus \$2 tax additional, the puts at so many points below the ruling market price, the calls above, the spread depending on the stock itself and market conditions at the time. Puts and calls are generally regarded as very inexpensive means of speculating. That is to say, that if one believes that United States Steel is going to rise in price, one buys an option on one hundred

¹ Some interesting rules for speculation can be found in the book by Edwin Lefevre ("The Reminiscences of a Stock Operator").

shares at, say, four points above the prevailing price. If, within thirty days, the stock goes up more than four points plus the one and three-eighths points paid for the call, it is possible to exercise the option, sell the stock, and realize a profit. It is not commonly known, however, that the sellers of options have usually figured it out very carefully that on the average United States Steel will not move five and three-eighths points in thirty days. Each stock on which options are obtainable, except in unusual cases, are equally carefully figured. The odds are evidently against puts and calls being profitable when used in this manner.

Their proper use is as insurance against the unexpected and the reduction of risk. Suppose a speculator is pretty well convinced that the market is approaching its top and that a downward turn is indicated by fundamental conditions. This is the time for him to buy calls, or options to purchase. When he thinks it is time to sell he can go short, with the assurance that if he is wrong or if some unlooked for development arises, he can repurchase his stock, on which he holds an option, at a definitely stated price known beforehand. His loss is limited. In like manner the buyer of stock, if he feels that he is perhaps assuming an undue risk, can definitely limit his loss by buying an option to sell at a stated price. There are men who, being close to the market and desirous of trying for short turns, have acquired options and traded against them several times in a short period

with no intention of exercising them unless caught in a hole. In such cases the cost is strictly an insurance premium.

There is still another manner in which the risks of speculation and of investment can be reduced. The New York Stock Exchange has, as the result of long experience, built up a set of rules designed to protect the broker and his customers. Some of these rules are onerous and seem unnecessary to the layman, as well as to the thoughtless broker. In the stress of competition for business some brokers have failed to keep to the spirit of the rules and have made exceptions in favor of privileged customers in order to get their patronage. Those who do business with men of this character and who think they are being rendered a favor are adding two elements of risk to their transactions. First, they are, with open eyes, subscribing to the removal of restrictions set up for their own protection; and secondly, they are putting their financial dealings into the hands of those who are, by their very acts, proving themselves unworthy of the trust being imposed in them. These added risks can be obviated only by the choice of brokers who "lean backwards" in holding to the rules.

Speculation is the use of foresight and the capitalization of careful study and investigation. It can be a very stabilizing influence on the markets and the source of excellent profits. It has inherent elements of risk which can be to some extent guarded against, not the least of which is the employment of a con-

servative, careful, strictly honest broker. A knowledge of speculation is not without its value to the investor, who is, after all, usually speculating in some degree, or should be if he would maintain his principal.

THE INVESTMENT TRUST

It will be said that such a scientific method of investing as has been outlined in previous chapters is impossible to the small investor who has not enough funds to spread over many types of securities, nor the time or information required to invest in such a manner. This is a very real objection. But our English cousins, who have much to teach us in finance and securities and whose methods of financing will be drawn upon later for suggestions for this country, have found a way to meet the problems of the small investor, or, as a matter of fact, any investor who would like to have his money handled in the most scientific manner by men trained in security analysis and the investment of money. This is the use of the Investment Trust.

Investment Trusts have existed in England and Scotland for some fifty years, and have had an excellent record.¹ In brief, these organizations raise money through the sale of their own securities to the general public. The funds so raised are then invested under the guidance of a staff of experts in the most careful and scientific manner possible. These trusts are much

¹It is realized that some of these trusts were originally formed to take advantage of low money rates in England coincident with panic conditions in the United States, but they have continued to prosper.

like banks except that they deal entirely in securities rather than in liquid capital. They buy stocks or bonds in any part of the world after a most careful investigation. Their purchases are predicated upon a study which gives them reason to believe that the return being paid, or confidently to be expected, will be something more than enough to compensate for the risk being taken. They expect to make a business profit in their investments as well as to receive an income. The income received comes from the interest and dividends collected on the securities owned, and from the profits made by buying either stocks or bonds which their investigations show to be selling below intrinsic value.

Perhaps a clearer idea of the investment trust would be given if the organization and activities of a hypothetical trust were described.

Suppose it were the aim of the organizers of the trust to obtain \$1,000,000. This might be done by offering for subscription some bonds, preferred stock, and common stock. From the point of view of the common shareholders the issuance of bonds and preferred stock would be excellent, for then any return over the outlay called for by the charges of the senior securities would accrue to the common stock. But, after all, the real reason to invest in the securities of an investment trust is not only the security thereby obtained, but the prospect of gradually increasing return. It seems proper, therefore, to limit the capitalization to common stock only. And there is no reason

to have shares with any nominal or par value. Each share would represent a proportionate interest in the whole fund so that no par value common stock best suits the situation.

The organization includes the gathering together of a staff of experts. Such a staff will probably contain one man thoroughly familiar with railroad securities, another familiar with public utilities, still another who knows industrial securities. The staff can be rounded out with one bond expert and one stock expert and perhaps one familiar with commercial paper. These men would be the ones who would analyze and report on the companies whose securities had been suggested for purchase; they would originate the proposals as to the stocks or bonds to be bought. The final decision would be in the hands of a board of trustees carefully chosen because of their records and financial abilities, men whose names carried exceptional weight.

Having succeeded in raising the million dollars, this organization would proceed to invest it. The by-laws would probably forbid the use of more than a certain percentage of the combined capital and surplus in the securities of one company. Except for United States Government securities, and perhaps those of Great Britain, the limit might be as high as 10 per cent but would more likely be 5 per cent. This would mean a fairly wide diversification. But the field of such an institution would be world-wide. Investments could, proceeding slowly, of course, be made in Europe,

Africa, South America, or other places, as well as in the United States. It is rare indeed that all parts of the world are at one time in a depression. The trust would in this manner be fairly well assured that while some of its interests might be doing badly in one place they would likely be doing well elsewhere. The investment trust makes possible the most complete diversification with all its advantages. The disadvantage to an individual of over diversification is eliminated because there is a staff equipped and able to keep posted on a large number of securities.

An institution organized along these lines should to-day be able to obtain an average return of 6 per cent upon the money at its command. With the care that could be expected in the choice of securities and the sources of information which would be available, there should be every prospect also of business profits. The dividends paid should be only from the interest and dividends received by the trust, such profits as are made should go into surplus and be used in adding to the capital funds available for investment. The profits would thereby continually add to the asset value of the stock and make possible the growth of the principal fund and gradually the increase of dividends. This would mean the same appreciation in value as is witnessed in the stocks of conservatively managed banks.

The investor who owns the stock of an investment trust holds only one security, but that one certificate represents an interest in many securities purchased

after careful investigation. It represents an interest in a fund which is managed along the most approved lines. The investment trust must, in England, be a source of great relief to the small investor who cannot under the circumstances do himself justice and who otherwise would worry and fuss over his small holdings as does the average American. It should also be a Godsend to the person who is forced to spend much time abroad and who is out of touch with current conditions. He should find the investment trust the best means by which to give his funds a combination of good security with the prospect of gradual appreciation in principal.

There is one great weakness in the investment trust, or great strength as the case may be. Its success is entirely and absolutely dependent upon the character of its management. Almost the only question which the prospective investor in such a trust need ask is, who are the men who will handle the fund? But, after all, this is the question which should be asked by every man before he chooses his bank, his investment banker, or his broker.

These trusts can have the same value to the community as a whole as any large financial institution such as banks and insurance companies. That is to say that they will always stand ready to lend money or to participate in any sound enterprise, providing always that the securities offered to it are on a basis which will give it a fair run for its money.

The record of the investment trusts in England and

Scotland have been excellent. It has been particularly noteworthy that during the last ten years, in spite of the Great War and the disorganized condition of Europe since, that a great many of them were, in 1922, paying higher dividends than in 1913. Some reduced their dividends slightly during the first years of the war (a very few even raised the rate of dividends) but since that time they have in most cases not only resumed the former rates paid in peace times, but have been able to pay more. The record over this trying period is pretty fair proof of the solid foundation on which they have been built.

There has been but little use of the investment trust in America. Small reason seems to exist as to why this should be the case. It is to be hoped that the idea can be made use of here, for it has a real field of usefulness not only to the average investor and the man unable to keep himself posted, but to the community—as a whole.

ENGLISH METHODS

The discussion so far has dealt with the type of service which it seems the investor should receive and which the investment banker and broker should give as part of his job in the present economic machine. It has also dealt with the difficulties of receiving or giving such a service under the present system of issuing and distributing securities. There remains the problem of how the system can be changed so that these things can be done with profit to the investor, to industry, and to the banker and broker.

In tackling the problem of eliminating some of the evils which are present in our method of issuing and distributing securities, it is natural that we should study the manner in which industry is financed elsewhere, and quite natural that we should turn to the English market because that is not only the one in which the conditions are most similar to our own, but it is still the preëminent money market of the world.

As early as 1844, the English found themselves faced with many of the factors which are now present in our situation. In that year the Joint Stock Companies Act was passed. Since then there have been others, culminating finally in the Companies Act of 1908 with subsequent changes as to detail. Through this long period of years there has gradually de-

veloped a method of controlling the issue of securities which, without putting upon any governmental body the slightest tinge of responsibility for determining the value of securities, assures the public of the necessary information on which a judgment of value may be reached. The fundamental features of what are now known as the British Companies Acts are the insistence upon full and complete information being furnished to the general public, and the holding personally responsible for the correctness of this information all those in charge of the company's affairs, including the directors. According to the English law, before securities can be offered for sale, or publicly traded in, there must be filed with the Registrar of Companies at Somerset House a prospectus in a form prescribed by the State containing certain basic data, and the promoters, organizers, and officers are civilly and criminally responsible for the truthfulness of the information. The mere filing of the prospectus operates as a permit of issue, the State thereby is burdened only with the responsibility of seeing that the information is in proper form and cannot be said to have in any way passed judgment on the merits of the securities. During the distribution of the issues, all circulars, advertisements, or selling representations are, by reference, required to incorporate in them the prospectus filed at Somerset House.

Naturally, the effectiveness of the law lies in the information which must be included in the prospectus. This must be dated and signed by every person named

as a director or by his agent. It contains the essence of what, in this country, are known as the articles of incorporation; the names, addresses and descriptions of the signers and the number of shares subscribed by them; the number of founders, management or deferred shares and the interest of the holders in the property and in profits of the company; directors' shares and the particulars as to their remuneration, their names, descriptions and addresses; details as to the subscription price, payment, etc.; the amount of money necessary to proceed to business so that companies will not begin business after selling some securities but not enough to assure their success, and promptly fail for lack of capital; details as to the securities under contract to be issued; the names and addresses of the vendors of any property actually or about to be purchased or acquired which is to be paid for out of the proceeds of the issue, and details as to how payment is to be made. This is intended, not to prevent the issue of watered stock, but to disclose the amount of water therein. There is also required a statement of the amount paid within the preceding two years, or payable as underwriting commissions, the estimated preliminary expenses including the amount paid or intended to be paid the promotor, and the consideration for any such payment. Finally, the dates of, and parties to, any material contract, with the exception of those made in the ordinary course of business or those made two years previous to the date of the prospectus. There is required the names

of the auditors and full particulars of the nature and extent of the interest of every director in the promotion of the company.

The British Companies Acts are aimed to prevent the suppression of material facts, the most common way by which investors are led astray; it is often said that it is not what is in a circular that counts, but what is left out. The law tries to disclose the amount of the stock the directors have in the company and makes unknown in England the "dummy" director. It prevents newly formed concerns from getting a part of their money, but not a sufficient amount, so that they cannot proceed to do business on a shoestring and inevitably dissipate the funds they have received. Finally, the law aims to disclose, but not to regulate, the use of the public's money in paying inflated profits to some syndicate who sold the property to the promoters. On the whole, it will be evident that the information called for is only that which a banker should have before identifying himself with the securities of a company. Full and accurate information is placed within the reach of all and no hardship or undue restriction on legitimate business is involved. As a matter of fact, it is probable that the forced disclosure of basic data which emphasizes the security of sound bonds and stocks tends rather to direct the flow of funds away from the unsound and toward the better grade enterprises and thereby adds to the economic strength of the country.

The British Companies Acts are not perfect; they

cannot prevent the swindling of the gullible nor the sale of non-existent securities by crooks. Experience has also shown that the responsibility for inaccurate information in extending only to the original subscription does not go far enough; it should be a "continuing warranty," as the legal phrase has it, and should give the power of recovery of damages to any purchaser of securities who can show that he depended upon information which was false. It is further true that the division of the United States into many separate sovereign units presents a problem in regard to the method of applying the principles here. It is so evident, however, that even though swindling and thievery cannot be eliminated, the forced use of full publicity raises the issue of legitimate securities to a higher plane, and some attempt should be made to apply the principles of the British Companies Acts in this country. Current experience leads to the belief that legislation of one sort or another will be introduced to regulate security issues and it is, therefore, suggested that before improper legislation becomes law, those responsible for the legitimate investment business of the nation forestall such laws by advocating the application of the principles of the British Companies Acts to the United States, as has already been done in Canada.

It has been suggested that such legislation should provide for a Registrar of Securities in New York and in Washington to act solely as recording officers. Every company whose securities can be said to be in

the hands of the public or traded in by the public should file a statement, or "prospectus," containing certain data, and all publicity or sales representations should include, by reference, this prospectus. This data should be brought up to date in all respects at least once a year and immediately before each new issue of securities. The information to be filed should contain the essence of the articles of incorporation; the names and addresses of each of the "management" together with a summary of their business experience and interest in the company; full details of capitalization and an itemized statement of the consideration for which the securities have been issued; detailed balance sheets, including a statement of contingent liabilities; specific purpose of present issue and details as to the proposed application of proceeds; full details of remuneration of promotor or underwriter; all pertinent facts concerning the property, rights and interests to be acquired; minimum amount of capital to be subscribed before beginning business; details of issues floated in two previous years and the amount and application of proceeds; details of material contracts, except those entered into in the ordinary course of business or over two years old; detailed statement of the interest of each of the management in the promotion of the company or in the property to be acquired; and, if an oil or mining company, a copy of an expert's report on the property. It might also be required to file identical information in regard to any subsidiary of which the parent company holds actual

or even working control. It is difficult to see where the filing of such information would prove restrictive to legitimate enterprises, and although there are many details to be worked out it is offered as a suggestion which, if adopted, should tend to bring increased value to good securities by giving the investor greater confidence in those of companies about which he knows he can get full information.

So much for the issue of securities. The English methods of distribution are also at variance with ours and are worth reviewing because they have eliminated some of the evils inherent in the American system. On the whole, there is a decidedly different atmosphere surrounding their methods of distribution and it arises from the very inception of an issue. In this country, industry is usually guaranteed necessary funds by an outright purchase of the company's securities which are resold to investors. In England, the guaranty takes the form of an offering for subscription, the underwriters, in return for a commission, agreeing to take the unsold portion. It will, of course, be said that to all intents and purposes this is identically the same thing, and on the surface this seems to be the case. But in the United States the transaction takes immediately the form of merchandising with all its consequent faults and lack of professional atmosphere, while in London the transaction is one of a professional service which the banker renders the company. He advises as to the type of offering which should prove attractive to the investing public and then in-

tures the company against the failure of the offering for which services he is paid a commission. While, therefore, it looks as though the two systems were alike, in the one there is the necessity for a force of salesmen and dependence thereon, in the other the banker is in such a position that if the security is not rightly priced and sufficiently attractive to sell itself, he is, in the parlance, "hooked."

And there is another difference. As soon as public trading begins to take place in a new issue, it is known just how much the underwriters had to take and there is no artificial market, the members of syndicates being privileged to sell as they please. If the issue has been priced too high, it promptly goes to a discount. This constitutes another reason why the banker must see that the issue is designed to be attractive and in proper line with the market. This care makes it rare for London issues to vary much from the offering price even though the issue was unsuccessful. And it is also the reason why London rarely experiences that customary New York announcement, "The syndicate has been terminated, and the bonds now have a free market," quickly followed by a downward plunge of prices, leaving every one who purchased the security with less confidence in the investment banker than ever. The number of experiences of this kind which the American market has experienced in recent years makes one frankly wonder how a new issue can ever be sold, and fills one with admiration for the salesmanship of the bondman.

Reviewing the London method of distributing securities brings out clearly why it is that bond salesmen are practically unknown there. It explains also why it is that investment bankers in England have been able to build up a real clientele of people who constantly seek their advice and who, having full confidence in them and knowing that their interests will have first consideration; go to their bankers as they do to their doctors or solicitors.

It will be said that, after all, some one must pay for distributing securities and it might as well be the investing public as industry. The point is, however, that the English methods have made unnecessary the immense overhead of a sales force and the cost of distribution is, therefore, low. The saving has been passed on to industry through a much smaller underwriting cost than prevails here. Both investors and industry are better off, and the banker apparently manages to get a good living.

It is, therefore, suggested that steps be taken to adopt in the United States the London methods of security distribution. It should in time come to be considered unethical for an issuing house to solicit subscriptions for new securities from its own clientele. If a firm's customers, of their own accord, and having sufficient confidence in the banker to do so, wish to subscribe, well and good, but the *selling* of securities is out of place as a professional service. The investor will get a fairer deal if securities are underwritten rather than merchandised. It certainly seems reason-

able that before securities reach the ultimate consumer they should go through the acid test of judgment by the financial community, in other words, those who have the knowledge and training necessary to make such a judgment, and the judgment should not be warped by the knowledge that, if wrong, there is nevertheless a sales force to lift the load. Let security selling be, therefore, limited to approaching banks, insurance companies, and dealers. It should be unethical to have a supported market for new issues. If, after a reasonable length of time, the issue has not sold itself, public trading without artificial support should be allowed. Such support and fixed selling price which is so customary in the United States is only necessary in order to give salesmen a chance to work, and is not only probably contrary to the Sherman Anti-Trust Act and in restraint of trade, but also directly contrary to the spirit of the New York Stock Exchange, which prides itself on maintaining a free market.

There has been much thought given to the problem of eliminating the "investment guaranteed" market. This is the name given to under-cover dealings which take place in newly issued securities which cannot be sold at the set price. It is virtually the sale of securities directly contrary to a syndicate agreement which has provided for the maintenance of the offering price. The name comes from the fact that a syndicate participant will break his contract and sell at a lower price if his purchaser will guarantee that the bonds will go into investors' hands and not come back to him via

the supported market. The anxiety to sell arises from the fact that when a selling campaign is a failure the members of the syndicate usually compete with each other in selling in the open market the moment the agreement expires. "Investment guaranteed" selling is an attempt to get out from under before this happens. It must be admitted that this type of dealing belies Wall Street's inherent honesty. Wall Street itself has done much in the last two years to eliminate this practice, and those who deal in this manner are losing their standing. It is nevertheless suggested that if securities were priced with a greater eye to the investor and if syndicate members were allowed to sell at will as soon as public trading starts, there would not only be no need of such underhand selling, but less desire on the part of dealers to throw out securities. The markets for new issues would thereby be far more stabilized than they now are.

It has been said that New York will soon replace London as the financial center of the world, but it has not done so yet. It can be laid down as a general rule that those who can produce a product or render a service most cheaply will get the business. London can distribute securities with more certainty and at a lower cost than we can, and when more normal times bring a closer relationship between the two money markets, unless we fit ourselves to distribute more cheaply, England will continue to have first call on most of the attractive new issues of world importance.

We can, therefore, learn much from across the water,

both as to the issue of securities and as to their distribution. In the first place, they assure their investors of all the necessary information on which to base a judgment of values. Secondly, the circumstances under which distribution takes place makes as reasonably certain as may be that the offering of new issues will be attractive to the buyer and will not have to be "sold." These two factors alone tend to divert money from worthless securities and make larger sums available for legitimate enterprises, and tend to bring the investor to the banker so that the latter's costs are low. This saving is passed on to industry in lower charges for investment banking services. In two ways, therefore, is the economic strength of the nation made greater.

A CODE OF ETHICS¹

In correcting the evils to be found in our system of security distribution it will be desirable to avoid as far as possible the necessity for legislation. The resort to law is excusable only when it is a case of raising the plane of competition of all those engaged in a given industry and then not entirely justifiable if it puts it at a disadvantage in competing with a similar industry in other countries. But if the plane of competition can be raised by the industry itself without resort to legal means, so much the better. The profession of law furnishes an excellent example to the "investment profession," for the two are similar in several respects.

The similarity is pointed in two particulars. In the olden days the lawyer did not stand very high in the community, but his code of honor and his methods have given him a high place in the present-day community. So with the banker—he is often distrusted; true, by people who know no better; but perhaps the universal adoption of a canon of ethics would raise his place in the esteem of the country as a whole. The similarity comes again in the fact that the banker himself very often speaks with pride of being in a

¹ The material for this chapter was obtained from the *Canons of Ethics of the American Bar Association* which will be found as an appendix to *Cases on Legal Ethics—American Casebook Series*—by George P. Costigan, Jr.

profession; all the more reason why he should do everything to put himself in the professional atmosphere and to govern his conduct by professional rules. The adoption of a code of ethics would be a splendid support to such statutes as may be required to correct existing evils, and would reduce the necessity for laws.

As in the case of lawyers, no code or set of rules can be framed which will definitely outline the duties of an investment banker or a broker in the varying phases of his duties to corporations and to individuals, but a general guide, like that of the American Bar Association, can be set up. "Laws will not make a community virtuous, nor will canons of ethics make dishonorable men honorable. Nevertheless, in a democratic community, good laws help to raise and strengthen the standard of social virtue and canons of professional ethics similarly tend to raise and to strengthen the standard of professional honor" (The Outlook, Vol. 89, p. 408, June 27, 1908). "Such a code is valuable chiefly as an expression of public opinion, and its value, therefore, will depend upon the degree of social courage with which the standard it furnishes is enforced by the bar in different communities."

It is not desirable here to try to set up a code of ethics for the investment profession; that is its own privilege. Yet some suggestions following the lines of the ethics of the American Bar may not be out of place by way of illustration.

In the first place, it should be declared dishonorable for a banker to fail to disclose any information essen-

tial to the formation of a sound judgment of the securities he offers. Unfortunately, it is only too true that it is what is left out of the ordinary circular which is important, not what it contains. He should be required to disclose his position to all parties in a transaction. He should not represent conflicting interests; that is, in the same deal look out for the interests of a corporation and try to serve the investor; it cannot be done fairly to both. His relationship to clients should be confidential. He should endeavor to obtain full knowledge of a client's position before advising him. He should not be allowed to use selling arguments which, even though truthful, knowingly lead clients astray. (The extreme example of this is the current practice among fly-by-night houses which offer oil or mining shares with detailed information about the riches of Mr. Rockefeller, or details of the enormous profits made from other mines.)

Some examples from the Canons of the American Bar Association may be of interest.

"In fixing fees it should never be forgotten that the profession is a branch of the administration of justice and not a mere money-getting trade." The "investment profession" is an essential part in the economic machine intended to finance industry and advise on securities; bankers should assure themselves that the funds they raise will go to a good economic purpose.

". . . it is dishonorable to avoid performance of an agreement fairly made because it is not reduced to writing, as required by the rules of the Court." Cer-

tainly the New York Stock Exchange is already the greatest exponent of this canon.

"The most worthy and effective advertisement possible, even for a young lawyer, and especially with his brother lawyers, is the establishment of a well-merited reputation for professional capacity and fidelity to trust." In their advertising, the members of the New York Stock Exchange are at a great disadvantage with banks and other non-members because of the desire of that body to advertise in no way which would smack of the unethical and fly-by-night variety. If all brokers and dealers in securities could be limited to conservative advertisements, it would not only obviate the unfair advantage which favors especially the dishonorable, but would raise the plane of the whole investment profession.

"Lawyers should expose without fear or favor before the proper tribunals corrupt and dishonest conduct in the profession." It is granted that few men like to tell tales "out of school," but it is nevertheless true that unfair and unethical practices in "the Street," rare as they are, are sometimes covered up when it might be best to disclose them. There have been cases when the strictest Stock Exchange rules have been broken and other members, knowing of it, have not reported the facts.

It might be possible to have the proposed code deal with such practices as that of announcing an issue sold before every bond or share has left the hands of the announced underwriters, and to deal with the question

of limiting the life of syndicates except under the most unusual emergency conditions.

In any case, such a code will stress the fiduciary position in which a banker or broker stands when advising clients, whether they be seeking funds or desirous of investing.

The suggestion is here made that the Investment Bankers Association, or a similar body, compile a code of ethics for the investment profession, and that all members be made to subscribe to it as a condition to their membership; that this body have a committee to hear cases of unethical conduct referred to it with power to "disbar" or deprive a dealer or broker of his membership. If this were done, it should be widely advertised so that investors might know that its membership had been raised to the high professional plane of the members of the American Bar. Certainly it seems reasonable to suppose that such action on the part of the Investment Bankers Association would give it a greatly enhanced prestige, however great its prestige already is, and it might serve to curtail some of the practices now current to which there is so much objection. A code of ethics should be a great support to the attempt to correct some of the evils previously reviewed without resort to law, and an excellent background for the "investment profession."

"But above all a lawyer will find his highest honor in a deserved reputation for fidelity to private trust and to public duty, as an honest man and a patriotic and loyal citizen."

AN IDEAL INVESTMENT HOUSE

The investment banker, as organized to-day, quite naturally finds it difficult to fulfill what, it is maintained, are his two economic functions. His whole organization is built upon the foundation of merchandising securities. For this he usually has a buying department, which is particularly concerned with getting new "business," that is, issues to underwrite or buy. In the case of the largest houses, like J. P. Morgan & Co., or Kuhn, Loeb & Co., they have their direct connections with various railroads and other concerns which regularly use them as their bankers. But these houses do very little in the way of retail selling, limiting themselves to the function of underwriting and wholesale distribution. They may distribute to individuals and corporations, but they do not have salesmen who place securities in the ordinary manner. These houses have a relationship to the various concerns for whom they are bankers very like that which exists in England. The majority of other investment firms who underwrite or originate issues may have similar fiscal relationships, but have also a selling force which must be supported. Hence, the need of a buying department consisting of men who actively search for and solicit underwritings to keep the gaping mouths of the salesmen fed.

It has been pointed out that, while many of the men who sell stocks and bonds have an excellent knowledge of securities, too many of them have been hired either because their personality, their aggressiveness, or other qualities give them the ability to sell. They are not taught judgment so much as salesmanship.

Tying in the buying and selling departments, there are also those of the cashier, trading, statistical departments, etc. The cashiers take care of the securities, receive those sold for customers and deliver them, obtain those bought and make such disposition of them as the customers instruct, collect checks, coupons, drafts, etc., and take care of securities left with the house for safe-keeping. This department makes the loans, substitutes collateral, and supervises the relations between the firm and the banks. The detail in the work of the cashier and his department is enormous and costly. The ordinary investor little realizes the amount of work and the expense thereof which is entailed in handling securities, all for a return of a little over one-eighth of one per cent. And a great deal of detail work, not only of the cashier, but everyone else in an investment firm or brokerage house, is purely gratuitous.

Such is the present organization, the buying of securities, the payment for them by the cashier, and their distribution by the salesmen. To put the investment business on a professional basis will require some changes in the organization of the average firm. In the first place, the buying and selling departments

should be completely separated (except in so far as each would contribute information to the other), and they might be differently named in order to better state their functions under the plan proposed. The buying department would become the Fiscal Department. It would be its business to look after the interests of corporations and to advise as to the best time and manner of financing its requirements. This would constitute a professional service to the concern seeking money. The Fiscal Department could then underwrite the company's securities and offer them for subscription. It could, as now, enlist partners in the enterprise. But it would not deal with the individual investor directly. It could place the new issue with banks, insurance companies, etc., and with dealers or jobbers, those who might be willing to take a block of securities because they considered them to be properly priced and a probable source of profit. The issue would go through the acid test of the judgment of the financial community before going to the ultimate consumer; at least, it would not depend upon salesmanship for its success.

Syndicates so formed should be of short duration and not allowed to extend for months. If the issue has been properly handled and fairly priced, it will not be necessary to have long syndicates, and, if not so handled, the underwriters should take the securities and hold them as is done in England.

The selling department would become the Investment Department. Its point of view would be entirely

that of the investor. Its personnel would be made up of men of good judgment and they would obtain their clientele in the same manner as do doctors, lawyers, or other professional men—by the building of reputations. The pay of these men would be by salary rather than commissions, so that their care of the investor would not be lessened through the temptations of a better return by placing one security rather than another. Quite naturally the size of the salary would be proportionate to the business done. Should the time ever come when underwriting syndicates will not support their new issues, but will depend upon their value and fairness of price, the Investment Department could take on new securities for its own account, that is, subscribe to the underwritings of others when they felt that the price was right from the point of view of the investor. In any case, there is no reason why the department should not pick up securities which are selling at attractive prices and hold them for those investors for whom they would be suitable, providing at all times this department was impressed with the fact that its business was a professional service to the investor.

The Investment Department should cover the whole security field. It should be capable of advising as to stocks or bonds and as to railroads, public utilities, governmental, municipal, and industrial securities. There is no reason why it should not be a member of the New York Stock Exchange. Many investment firms to-day refuse to join the Exchange, and discour-

age the purchase of any stocks whatever. The reason given is that it interferes with the selling of bonds and investment securities. When a firm has the facilities for buying stocks it is more difficult to direct a client's money always into underwritings in which the profit is greater. If the professional attitude should prevail, and stocks be used with the discretion previously suggested, this reason would have no ground; in fact, membership in the Exchange would be a distinct asset to such a firm. The Investment Department should, then, cover the field and be prepared to give a true investment service to the clients of the house, a service not warped by the necessity to sell.

The Investment Department should be so organized that it can assume the burden of keeping its clients posted on conditions affecting their securities. It should have complete lists of the securities of each of those who deal through the firm. These should be cross indexed under the name of each company so that should special or unexpected conditions arise in some industry or company, reference to a card will give the names of all those clients interested in that company. They can then be notified and many losses cut short. Or perhaps some security will appear to be higher than seems warranted under the conditions. The holders can be given the opinion held by the house and will often be able to save a profit which might later be gone. This is a service which is of real value, and, while onerous, is a good income producer to the firm. It would be objected that this is assuming too much

responsibility. It is true that often this is a thankless job, but if it is undertaken, the investor must first be impressed with the fact that the firm will do the best it can, but it does not expect to be infallible.

The Cashiers' Department would need no change. But the Statistical Department can have an addition of great value. This would be the services of a man trained in the use and interpretation of business and economic statistics. Such a man would keep the firm posted on the development of economic events and the business cycle. He would advise the Fiscal Department on its end and the Investment Department on its end. The economist can be of great assistance in gauging the proper time for corporations to borrow and help in advising those looking out for the investor as to the time to buy long or short term bonds, or stocks. He would also be of valuable assistance to the cashier who would be able to vary his borrowings between time and call money on a more scientific basis than is now generally done. It is true that many now look upon the economist as being either too academic, or a variety of statistical bug, but it is, nevertheless, a fact that many banks and large corporations are finding them of sufficient value to be placed in high executive positions. If banks, which deal in short-time liquid funds, can find use for such a man, certainly the investment banker who deals in long-time funds used generally in fixed capital can have just so much greater a use for the economist.

There is the added fact that there is open a wide field for economic research in securities. This was touched upon earlier. The point is that the firm which will undertake such research work will probably discover much that will be the source of great profit, and, in addition, add greatly to its prestige.

It will be said that if all investment houses were organized along the lines proposed there would be no place for the houses which specialize in public utilities, municipals, railroads, etc. The fact is that such houses cannot give a true professional service to their clients because their interest is too largely to sell one type of security. Their place in the scheme of things outlined is as jobbers dealing not with the investor but with the banking houses. With their specialized knowledge they can underwrite and place with those who deal with the investor. Or they can pick up blocks of bonds which they know to be underpriced and hold them for resale to investment firms which may come to depend upon their judgment in their particular line. They will have no selling forces and no selling expenses to speak of; their overhead will be extremely low and their profits probably at least as great as under present conditions.

While many will agree that an investment firm so organized will give a professional service both in mobilizing funds and in caring for them, the same people will probably ask how it will be possible to make any money out of it. It is essential that the business should

be sufficiently profitable to attract into it the more intelligent and highest grade men, and it is to the interest of the investor to recognize that fact. It has been pointed out earlier that the distribution of securities on value rather than selling ability should reduce the cost thereof to both the corporation and to the banker. The aspect of the professional service, which should appeal to the salesman, is that it is carrying to its ultimate conclusion the belief that "the best advertisement is a satisfied customer." In the first place, the giving of such a service should in itself assure to the firm the whole of any person's security business. It can easily be made plain to customers that otherwise they cannot expect real attention to their interests. Secondly, the personnel of the Investment Department, not being forced to roam the street and warm benches outside of offices, can give their whole time to actual dealings with customers. Clients will come to a firm so organized readily enough, and sales and advertising costs can be heavily cut down. Thirdly, the losses inherent in the practice of bidding high for securities in order to feed sales forces, and the losses arising from over-anxiety for new "business," will be largely eliminated. The very fact that securities will be placed on the basis of value will be an insurance and protection from loss to the banker not possible under present conditions. Finally, the bad-will naturally arising in clients who see their newly purchased securities selling very quickly below the price paid for them will be replaced by good-will on

which a money return may be expected. On the whole, it is not unreasonable to suppose that the actual net income of a firm giving an honest professional service will exceed that obtained under the existing system of security distribution.

A WORD TO THE INVESTOR

The purpose of this book has been to outline the service to which the investor is entitled and the obstacles which prevent the giving of such a service. Among the obstacles is the attitude of the ordinary investor himself who little realizes his true position and who fosters and abets the present system of security distribution.

. Americans are known for their ability to make money, but not so well for their ability to keep it. In part, this is due to the failure to recognize that investing is a business in itself, calling for trained and specialized ability. In part, it is due to misunderstanding of the real security of principal and interest—the constant supervision of the funds. And in part it is due to the rather general pride which nearly every man—and many women—takes in his own particular skill in choosing securities. If the investor wants to have the fun and pride of doing his own investing, and is willing to pay for his pleasure or take his profits as the case may be, well and good; but he should understand the causes of his losses when they come. But if he is laying away funds with which to build an estate and assure himself of an income upon which he can later be dependent, he should enlist in his service those expert in this line of endeavor, just as he calls upon

his doctor, lawyer, or other professional man trained in a particular line.

The evils of the present system of investment banking in the United States have been dwelt upon. Part of these evils lie at the door of the investor himself. Take, for instance, the question of bond salesmen in competition for an individual's business: Here one has the picture of several men, one after another, taking up the time of a busy person while they try to sell their wares. Each one of these is in the position of having to sell what he has at the moment, if he can, regardless of its suitability to the particular investor, because he is afraid that if he does not get the business at once, someone else—with a more glib tongue—will. As a result, the buyer obtains certain securities which more often than not are far from being those which he should have and which equally often are improperly priced.

Some investors will defend their position by saying that having three or four men competing for his business assures him of better service and often of better prices. It is true that where several houses are competing for one individual's business, one of these may be willing to make price concessions, especially on new issues.

The investor pats himself on the back for having been clever enough to save himself \$25 to \$50 in an investment of \$10,000 and proceeds to deal with a firm which has been dishonest enough to break its agreement with its syndicate partners. Is it worth the

money? And as for getting better service, he succeeds about as well as if when he were ill he had half a dozen doctors ringing his door bell, each begging for a chance to cure him. If doctors treated him in such a manner he would throw them all out and send for one in whom he had confidence and put himself in his hands.

So in the handling of investment funds, choose the banker in whom you have the most confidence and put yourself in his hands. As Mr. George E. Roberts, Vice-President and economist of the National City Bank, puts it in his book, "The Financing of Production":¹ "The financial sagacity of investors is measured largely by the skill with which they choose the investment banker who shall serve them." After choosing the banker, co-operate with him and take him into your confidence. Bankers have the same confidential relationships with their clients as have doctors and lawyers; if you cannot put your trust in him in the same manner, you have evidently picked the wrong banker.

By co-operating with him is meant the giving of all the necessary information on which he must depend to make a proper selection of securities. For instance, let the banker have your list of stocks and bonds already held, not only so that he may fit in such new ones as may be acquired, but also in order that he may be able to keep you posted on developments. In fact, you should ask him to go over your whole list at least every quarter and preferably once a month.

¹ Published by the American Chamber of Economics, New York, 1922, see page 34.

This matter of giving the banker a list has only recently had two striking proofs of its value. A salesman in a certain house was asked why it was that he never knew what securities his customers held. His reply was that he did not want to know, for if he did, he was forced to sell the customer something which would fit in his list and was thereby denied the personal satisfaction of selling the bond which returned him (the salesman) the most commission.

The second example is furnished by a partner in a prominent banking house. He has an intimate friend of wealth, to whom he has been making investment suggestions from time to time when the friend has had surplus funds. The banker thought he knew his friend's situation pretty well and prided himself on recommending those securities he felt were most suitable. Recently the friend-client gave him a full list of his holdings, and the banker, much to his astonishment, found that every recommendation he had made was unsuitable and failed properly to fit with the securities already held.

To give your investment advisor a complete list of your securities, and to advise him regarding the other sources of your income is a part of the co-operation which he must have. Since most investment bankers are as honest as can be, to put him in such a confidential relationship rather puts him on his honor to give the best thought-out advice, for he cannot assume the client's position to be what it is not. And it gives

him the foundation on which to make well-chosen suggestions.

Compare these two situations. In one there is the man who allows several houses to compete for his patronage, each one ignorant of his exact position, and each struggling, through salesmanship, to inveigle him into buying securities which may or may not be suitable for him, and which may or may not be properly priced. In the other is the man who has carefully chosen an investment adviser in whom he has confidence. This man's time is not wasted by constant calls from salesmen. When he has money to invest he informs his banker who, being assured of the business, can take his time, study the situation as it applies to the particular individual, and make his suggestions accordingly. Perhaps he deems it wise not to invest at the moment, or perhaps suitable securities are not available at fair prices; since he knows he is only postponing the business and is not taking any chance of losing it, he can advise accordingly.

Which investor gets the better service, and which in the long run handles his securities at least cost in time and money?

As an example of the broad-visioned service obtainable from a banker, it may be pointed out that while 7,000 trustees, many of them extremely conservative, were caught with New Haven stock, one Stock Exchange house had shifted its customers to American Telephone and Telegraph, while both were paying \$8

a share. This sort of thing can be done by those who spend their time at it, but it is difficult for those occupied at other things.

To sum up, the investor who would treat his savings as the basis of a fund which he hopes will yield him a fair return and which he hopes will grow, should acknowledge that the choice of securities and their care is the work of one trained in the business. The man who, engaged in another occupation and who unassisted does all his own investing, is like the man who would be his own lawyer, he—usually, not always by any means—has “a fool for a client.” He should select his investment banker in the same manner and with the same care as he selects his lawyer or his doctor. He should be sure that the firm is so organized that it can keep itself thoroughly posted as to general conditions and those in separate industries, not in a haphazard manner from the daily newspapers, but by experts in economic and business statistics. He should assure himself that their recommendations are based upon a real study of the companies involved. And he should believe in the soundness of the judgment of the firm’s personnel. He must recognize that the choice of securities depends upon foresight to an unusual degree and that no one, even the best, can be infallible, but he can rest assured that if he has picked his adviser in this manner, and if he will give full co-operation by furnishing complete information and promising the banker all his business in securities, he

will have about as few mistakes as are possible, and his profits should exceed his losses.

If the investor wants a professional service, he can get it—by knowing of what it consists and demanding it.

CONCLUSIONS

The investment banker, the broker, and the dealer in securities have a definite and essential place in the economic machine. It has always been their function to facilitate the mobilization of the capital required by expanding industry and the passage of capital from one industry to another. The great growth of the corporate form of doing business and the increasing size of industrial units have brought such an increase in the number and variety of securities that the care of invested funds has been vastly complicated. Those who deal in stocks and bonds seem to be under the obligation of assuming the added function of supervising the investments of their clients. Under the present system of issuing and distributing securities the first function is fulfilled, but it is fulfilled in such a way that, in addition to making possible many improper issues, the point of view of the investor has been largely lost. The dependence upon salesmanship rather than judgment and value is the outstanding feature. This is due in part to excessive competition for "business" and has itself aggravated the evils which gave it birth. The result is not only improper pieces of financing, but the issue of many new securities at prices too high for those of an unseasoned character. The two functions of the banker

must be strictly divided, for they cannot be accomplished simultaneously with justice to both industry and the investor. It is serving two masters whose interests are conflicting.

The service of the dealer in securities to industry and to investors can be put upon a professional basis. To do so will mean more careful work and greater study than is current except in exceptional quarters. It will probably mean the use of the economist and something more than a haphazard analysis of business and economic conditions. It will mean a more detailed study of corporations and their securities than is now made. It will mean some dependence upon the new science of the use and interpretation of business statistics, and the application of the principles of speculation—that is, foresight based upon careful, trained and intelligent study of complete information. There will probably be, too, greater research in securities thereby adding to the present knowledge.

There are undoubtedly those who will say that if everyone adopts such methods of investing the natural and absurd result would be that the markets would move neither up nor down. Should every one do so the result would be just that. As a matter of fact, it is becoming recognized that as economic information is spread the tendency will be to level the peaks and valleys of business cycles. The application of this has here been specifically to the security markets. It is not expected that the adoption of these methods will be general, but the more who do so, the greater

stabilization the security markets will have. Surely this is not an undesirable thing.

Since investors are those whose interests are being given most consideration, they will be expected to assist in bringing about the changes proposed. They will recognize that the best security of principal and income lies in constant supervision by those trained in the complicated process of choosing and watching securities. They will adopt the view that their interest lies in choosing their bankers carefully and in giving them full co-operation and refusing to allow themselves to be bothered by a constant stream of bond salesmen.

While the issue of securities must now conform to an accepted system, there are all kinds of bankers within that system. It is easy enough to find those who have character, integrity and judgment, so that even though the system remain unchanged, the investor can find those on whose judgment he can safely depend. In the long run, and regardless of methods, it is the character and judgment of the bankers that count.

Those interested in raising the plane of investment business will find much of value in the British Companies Acts, which force the disclosure of the complete information fundamental to a judgment of security values, but which do not put upon any governmental body the burden of passing upon their soundness as investments. They can draw upon the English methods of distribution which seem to be more nearly on

a professional basis than those in this country and which do not depend upon selling ability and pegged markets. The English Investment Trust is also an example which might be emulated to the advantage of the small investor and those who cannot be in constant touch with their financial advisers.

In making the necessary changes it is probable that the use of law can be minimized and given support if some bankers' organization would adopt a code of ethics to which members must subscribe as a condition to continued membership.

To such changes as may be made, investment houses would have to conform by revamping their internal organizations.

Bankers may object that any other than present methods will fail to give that return which is necessary in order to attract into the profession of investment banking the highest grade of men. It is believed, on the contrary, that it would tend to eliminate the competition and with it the lower grade and less financially responsible, and to increase the gross business of the soundly run firms; that it would largely reduce expenses; and that it would reduce the risks of the business and reduce losses; all of which would be reflected favorably in the income account of the high-grade financially strong firms.

What would all this accomplish?

It would tend to raise the plane of the investment business to that of a profession, add to its prestige, eliminate much of the criticism of "Wall Street," and

make possible a relationship between clients and bankers or brokers not now possible.

It would tend to direct the flow of funds away from unsound enterprises and into those which are good. It would reduce the cost of financing and help industry. It would reduce the losses of investors and of bankers. All these would be distinct additions to the economic welfare of the nation.

Finally, it would tend to forestall the introduction and passage of legislation which would be uneconomic and unsound. Mr. McClintic of Oklahoma has introduced a bill in the present Congress designed to place the issue of securities under the supervision of the Federal Trade Commission, *which would be required to pass upon the soundness of proposed issues as investments*. Would it be possible to propose anything worse for the investor or the country than to have a governmental body, swayed by politics, pass upon the soundness of investments? If the banking community does not take the initiative and direct legislation along proper lines, this is the type of law which may some day be on the statute books.

There seems to be much reason to hope for and expect great good and increased economic progress from the investment business when it not only adopts the viewpoint but surrounds itself with the atmosphere of a profession.

