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Author Investors' chronicle.

Title Practical investment. 1949

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PRACTICAL INVESTMENT

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A Text-Book Compiled
by
THE INVESTORS' CHRONICLE

London

Published by Eyre & Spottiswoode
for
THE INVESTORS' CHRONICLE LTD.

First Printed October 1949

*Made and printed in Great Britain
by The Thanet Press, Margate*

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INTRODUCTION

THIS book has its origins mainly in a series of articles which appeared week by week in *THE INVESTORS' CHRONICLE* under the heading "Notes for the Small Investor". The suggestion that these articles should be reprinted in book form came from many readers, a fact which encourages me to believe that this book, although it may seem to be "just another book on investment", will fill a real need. In planning the original articles, we had two advantages. First, as working financial journalists we obtained in the course of our day-to-day work an intimate knowledge of the type of questions investors are always asking. These range from "What exactly do you mean by the 'gearing' of a company's capital?" to "Please explain in simple terms how the Government can control the rate of interest". Secondly, as the articles got under way, so additional requests for explanatory and educational articles came rolling in. It is our hope, therefore, that this is not merely a book we wanted to write, but a book which investors wanted written.

The book is essentially a co-operative effort. Most of it was written by members of the editorial staff of *THE INVESTOR'S CHRONICLE*. Some chapters, however, represent the work of outside contributors to that paper, experts in fields calling for specialized knowledge. In these circumstances, it would be invidious to single out any particular contributor for special mention. I feel, however, that it should be recorded that the main task of preparing the subject matter of "Notes for the Small Investor" for publication in book form, and of bringing that subject matter up to date in the light of developments since the original articles were written, has been shouldered by Mr. W. A. Willis, who after serving *THE INVESTORS' CHRONICLE* for over forty years on its editorial staff got so into the habit of working that he found it impossible to stop, even in retirement.

H. E. W.

THE INVESTORS' CHRONICLE and
MONEY MARKET REVIEW

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CHAPTER I

STOCKS AND SHARES

Types of securities—Gilt-edged stocks—How interest rates affect them—Foreign bonds—Their speculative risks—The rights of Debentures—Pitfalls in Preference shares—Ordinary shares—Characteristics of equity shares—Their fluctuations relatively wide—Nominal value difficulties—Capital gearing—Priority percentages.

A SURVEY of the many facets of the vast field of investment may well begin with a discussion of the various types of stocks and shares. Securities fall into two main classifications—fixed interest issues and variable dividend securities, although sometimes, as with a Participating Preference share, one gets a mixture of both types, and not all ostensibly fixed interest issues deserve that title! The fixed interest issues are subdivided into many types—gilt-edged, short, medium, and long-dated, one-way option stocks, and irredeemables; foreign government and corporation loans; Debentures; and Preference shares. Variable dividend securities are usually Ordinary or Deferred shares, called “the equity”.

“Gilt-edged” is a generic term, covering, for example, British Government stocks, Home Corporations, Public Board issues (such as Port of London Authority and Metropolitan Water Board), Dominion Government stocks. Such stocks are of the highest investment calibre, and in the modern context are “much of a muchness” so far as the returns offered are concerned. They are virtually free from “trading risk”—although it was not always so, as holders of some Dominion stocks will remember—but are subject to the disadvantage that if the cost of living rises the purchasing power of their fixed income falls.

Their market prices are largely governed by the ruling long-term rate of interest. But here important distinctions arise. At those times when investors expect the rate of interest to fall, irredeemable issues will rise more than redeemable stocks, and long-dated redeemables will have more scope than short-dated issues. For example, if investors thought the long-term rate of interest was going to fall to 2 per cent and stay there, the 2½ per cent Treasury stock, “1975 or after”, which cannot be redeemed before 1975, would have greater scope than a “dated

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issue" with a shorter life than this. For the presumption would be that the dated issue would be converted to a 2 per cent basis so soon as possible, and investors would seek the assurance of $2\frac{1}{2}$ per cent until 1975 while the going was good.

But if investors expect a rise in interest rates, the reverse is true. They would prefer "dated issues", for the definite promise to repay provides some sheet-anchor (the effectiveness of which varies according to the nearness or distance of the redemption date) to govern the market price. On the other hand, a true irredeemable has no anchor whatsoever, and a "one-way option stock" (such as the Treasury $2\frac{1}{2}$'s already mentioned) is in this respect a snare and delusion, for there is no *obligation* to repay, and clearly the Government will not redeem a $2\frac{1}{2}$ per cent issue, if it has to pay, say, $3\frac{1}{2}$ per cent on the redemption moneys.

In a nutshell: The shorter the life of a loan, the lower the yield and the less (except sometimes in times of crisis) the fluctuations in market price. The longer the life, the higher the yield and the greater the fluctuations in price, with the yield and the fluctuations normally at their maximum in irredeemable stocks. "One-way option stocks" are in practice regarded as irredeemable if the optional redemption date is a long way off and the fixed interest rate near or below the current level of interest rates, e.g., Treasury $2\frac{1}{2}$'s. They are regarded as redeemable when the optional redemption date has passed if their interest rate is above or about the current rate; or, if their interest rate is above current rates, even though their redemption date may be some way ahead, e.g., $3\frac{1}{2}$ per cent War Loan, 1952 or after.

Foreign Bonds

FOREIGN government and corporation loans are fixed interest securities; at least, that was the original conception. In many cases, they have proved the opposite in practice. Sometimes their interest has been varied, often by the debtor's one-sided decision and always in the wrong direction, every few years. For many years, Chilean Government bonds had more the nature of an Ordinary share than a bond; their service varied from year to year, according to the prosperity of the nitrate and copper industries. Swingeing cuts in principal (i.e., in the capital amount originally borrowed by the debtor) are by no means unknown to foreign bondholders.

It remains true, nevertheless, that some foreign bonds have a very high investment status, and here the main determinant of

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prices, as with gilt-edged stocks, is the long-term rate of interest. Examples of high-grade foreign bonds are those of Argentina, Denmark and Uruguay. Such bonds will, of course, give a better yield than gilt-edged securities, despite their high standing. This is a measurement of the greater risks involved in even the best foreign investments—risks inherent in the lack of control by the lender and in the variations in exchange rates. On the latter score, even when loans are expressed in sterling, a depreciation in the value of the borrower's currency or appreciation in the lender's may increase the cost of the borrower's overseas debt service. A fall in the prices of primary products or goods, which means that greater quantities of such products and goods must be shipped to yield a given amount of money, is another factor which may increase the real burden of a debt to a borrower; a rise in prices, of course, has the opposite effect.

In an attempt to overcome the exchange risk, which might have deterred the investor from lending his money overseas, what is known as the "foreign currency clause" was introduced. This provides an option to the lender to demand payment of interest and principal in several currencies, which generally include one or two "hard" (or strong) currencies, such as the Swiss franc or U.S. dollar. Thus, in the event of a depreciation in the value of the lender's own currency, he can get more depreciated currency by demanding Swiss francs or U.S. dollars and converting them. There used to be what was known as the "gold clause" in many bond contracts, which provided for payment of the debt in gold, or its equivalent in currency; but this became so onerous with universal currency depreciation that most countries passed legislation to prevent its enforcement.

It is a sad fact that the great majority of foreign bonds are highly speculative holdings. The risks already mentioned are not unreasonable risks for the investor to shoulder. But, in addition, the holder of foreign bonds must reckon with war and revolution, famines and gluts, earthquakes and hurricanes, and other factors which may prevent even the most willing debtor from paying his dues. And, alas, many foreign borrowers are not willing. Growth of nationalism often leads to default when default is not justified by the facts of the case. And then, as often as not, once the price of the bonds is depressed by default, the debtor surreptitiously repatriates his bonds by purchases at knock-out prices.

It follows that foreign bond investment is a highly specialized field. Without such investment international trade is impossible, and it is to be hoped that Government action in such countries

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as our own and America will restore the prestige of foreign bonds. (At home, the Council of Foreign Bondholders, a quasi-official body, does what it can to protect bondholders' interests, but the history of our foreign investments shows that its accomplishments and powers are limited.) The small investor should proceed with circumspection in the foreign bond field, and must realize that, except in a select number of issues, he is speculating against factors which simply do not arise when the obligation or share is purely a domestic, United Kingdom affair. But for the man who likes a speculation, the foreign bond market offers a wide selection of fast-moving, and often low-priced, high-yielding stocks.

Debentures and Preference Shares

WITH Debentures we enter the realm of company finance. In this sphere Debentures are, or should be, the gilt-edged security. They are not part of a company's capital, but a debt, generally secured either on specific assets of the company or by a floating charge on all or some of its properties. The security is, in theory at least, enforceable by Debenture holders if their service is not met and if they refuse to agree to a moratorium. But it is often found that when the earning power necessary to provide the service is absent, the underlying assets are unsaleable, or saleable only at knock-out prices. A more efficacious remedy sometimes employed is to appoint a receiver and manager for the business in the Debenture-holders' interests; this individual endeavours to nurse the business back on to a solvent basis.

Debentures may be redeemable or irredeemable, or "one-way option" stocks (redeemable solely at the convenience of the borrower) and are sometimes convertible into Ordinary shares. Their interest is generally cumulative, and payable (within the resources of the company) whether earned or not. But non-cumulative or Income Debentures are by no means uncommon, and here holders' fortunes fluctuate directly with those of the company. Such "fancy" types of Debentures are not infrequently a by-product of a company's capital reconstruction, and thus may sometimes provide a warning that this particular financial venture was not always *À la* Lloyds.

There are also Participating Debentures, which rank for a share in the profits, generally on top of their fixed cumulative interest, and the title "Debenture" is often embellished by such phrases as "Prior Lien" or "Secured", which are self-explanatory, but sometimes gloss over an inferior security. The market prices

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of Debentures are governed first by the course of interest rates generally, and secondly by the measure of trading risk involved. They provide little or no hedge against inflation, but are useful yield sweeteners.

The Preference stock or share is the half-way house among securities in the world of company finance. Unlike the Debenture, it is part of a company's capital, and the Preference shareholder lacks the legal rights of the Debenture stockholder; he has no specific, enforceable security, and he cannot appoint a receiver. Like the Debenture, however, the Preference share has a prior claim to dividend before the Ordinary share ranks for payment, and like the Debenture, Preference shares can (since the 1929 Companies Act, now consolidated into the 1948 Act) be redeemable, either on definite, stated dates and terms, or at the borrower's option "on and after" a certain date. The great majority of Preference shares, however, are perpetual issues—unless, of course, the borrowing company goes into liquidation.

The great majority of them also rank for a fixed, cumulative dividend. That is to say that in contrast to the Ordinary share, whose dividends rise and fall with the company's profits, the reward of the Preference share should be regularly paid and fixed in amount, and if its payment is missed then it accumulates year by year until such time as the company can pay not only the current dividend, but arrears of past payments as well. This, the Cumulative Preference, is the most common type. But there are variations. There is, for example, the non-cumulative Preference, which ranks merely for a preferential rate of dividend year by year ahead of the Ordinary, but which forgoes the right to a dividend in respect of any year in which the directors decide not to pay one; in short, it accumulates no arrears of dividend. Then there is the Participating Preference, which is an attempt to give Preference shares an equity (or Ordinary share) element. In this type of share, the major part of the dividend is fixed, but over and above the fixed sum (which may be cumulative or non-cumulative) the shares participate in surplus profits with the Ordinary.

Without such a participation, a Preference share is subject to the same influences as other fixed interest securities (changes in interest rates, inflation, etc.), but the trading risk is an element which cannot be ignored by the Preference shareholder. Some Preference shares are very secure holdings, virtually gilt-edged, but in general it must be remembered that the Ordinary shareholders (and a company's direction and management are

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generally identified with the Ordinary) use Preference capital as a convenient means of raising relatively cheap money in order to gear up earnings on the equity. (Gearing is explained later in this chapter.) In consequence, the tendency is to give Preference shareholders the minimum in the way of voting rights and participation in surplus assets in the event of liquidation, and to attempt to "diddle" them when the need for a scheme to reconstruct the capital and "deal with" Preference arrears arises. There is also a tendency, particularly these days, to weight the redemption scales against Preference shares—to avoid any *obligation* to redeem, but to provide the company with an *option* to do so.

All this can be summed up by saying that Preference shares have their uses to both borrowers and lenders, but that they need watching by investors. They have their moments, of course. New issues of Preference shares tend to be more readily taken up than new Ordinary shares when the industrial sky is uncertain. But their fundamental weakness lies in the fact that they get few or none of the ha'pence (above their fixed rights) when things go well, but are apt to get more than their fair share of kicks if things go badly. The dangers of high interest bearing Preference shares in the event of liquidation have to be borne in mind. For instance, assuming a 6 per cent cumulative Preference £1 share stood quite reasonably at 30s. to yield 4 per cent (a not uncommon position), it would be a severe shock to a holder to find his shares peremptorily paid off at 20s. in a liquidation. Not all Preference shares in nationalized companies, for instance, have been safeguarded against this contingency. And the non-cumulative Preference, which has been known to be deprived of dividends (even when these are earned), to the ultimate benefit of the Ordinary shares, has justly been described as the lowest form of life in the company world!

Ordinary Shares: "The Equity"

WE have now arrived at the last of the main types of securities—Ordinary shares, commonly known to-day as equities. Sometimes, they are known as Deferred shares; sometimes, we get both Ordinary and Deferred in the same company. But the essential point is this—that the equity shareholders, however described, are the real owners of the business, subject only to the claims, both for capital and interest, of the prior charges (bank advances, Debentures and Preference capital, etc.).

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Ordinary shares are not, generally speaking, entitled to any fixed or cumulative dividend. (Exceptions are to be found in some bank and public utility undertakings, but these are not really equity shares in the usual meaning of the phrase.) On the other hand, Ordinary shares are entitled to whatever remains after the claims of the senior issues have been met, and usually the votes of the Ordinary shareholders control the company.

Very often the dividend on an Ordinary share will appear to be static, if not fixed (as was long the case with Imperial Chemical Ordinary), and at the time this book is going to press voluntary dividend limitation is a powerful influence in this connection. But even so, the benefit of the equity accrues to such shareholders; for if only part of a company's profits is declared in dividends the residue is ploughed back into the business and is used to acquire new assets and to build up reserves. These new assets and the profits they earn belong legally to the equity shareholders, again subject only to the claims of the senior issues.

Given a successfully managed company operating in an expanding industry, this ploughing back process brings over a period of years a natural growth in the value of the equity. In addition, a company, by adjusting the charges it makes to its customers for its goods and services, can keep its profits and dividends more or less in step with the rise in industrial costs and prices and the cost of living. Thus Ordinary shares provide an insurance (or a "hedge" as it is sometimes known) against a fall in the purchasing power of money brought about by an increase in the cost of living. This protection is entirely absent in the case of fixed interest securities. For these reasons, in the past at least, Ordinary shares in successful companies in expanding industries have been highly satisfactory long-term investments.

This fact, however, should not be allowed to obscure possible disadvantages of Ordinary shares, both as long-term and short-term holdings. On the long-term view, if a company is unsuccessful, or if it is operating in a declining industry, the brunt of any setback falls on the Ordinary shareholder. On the short-term view, it should be realized that from their nature Ordinary shares are subject to much more violent fluctuations than fixed interest securities. They can fall and, in the past, have fallen as abruptly as they rose so strikingly over the period 1940-47. It follows that the small investor who is unwilling to accept the risk of major capital fluctuations should pick his way carefully in Ordinary share markets. The rewards are there for the venturesome; but the risks must not be overlooked.

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Nominal Value Difficulties

ONE further aspect of Ordinary shares must be stressed, because it is often the source of much trouble these days. An Ordinary share, in the nature of things, can have no fixed or stated value. It represents literally a share, maybe a thousandth, a hundred-thousandth, a millionth or any other fraction of the residual value of a business after prior claims have been met. Now the worth of that residual value is never static. It may be steadily increasing; it may be falling, year after year. It may be suddenly reduced by some exceptional happening—such as an unavoidable trading loss—or it may be suddenly increased by a windfall profit. The essential point is that it is never the same, except by accident, from one day's end to the next. Yet British company law—and tradition—insists that Ordinary shares *must* have a fixed and stated value; they must be £1 or 10s. or 1s. shares, or whatever “denomination” is decided upon.

The results of this insistence on fixing a definite value on something the real value of which is highly fluid are most troublesome. Investors sometimes think that because a share with a nominal value of £1 stands in the market at “only” 5s., it must be cheap. Contrariwise, one often hears even quite sophisticated investors say they wouldn't touch a share with a nominal value of only 1s. because its market price is twenty times as great; “it must be dear”. Yet the £1 and the 1s. nominal values really have “nothing to do with the case”. What is relevant are the earning power and assets behind these shares. Having stated these general principles, one reservation may be made. If a 1s. share stands at 20s. it is almost certainly earning profits and paying dividends to justify that price. It is possibly paying a dividend of 100 per cent. Now this is politically a “vulnerable” dividend; it is open to criticism on the grounds that no company should pay 100 per cent each year. (Of course, if the company's shares had a nominal value of £1, its percentage dividend, which would absorb exactly the same amount of *money*, would be only 5 per cent.) Because of this ill-informed criticism of “high” dividends some investors mistrust shares whose market value is many times their nominal value. They may even prefer the £1 share standing at 5s. because the dividend is small enough to be politically beyond criticism. One can only say that things have come to a sad pass if investors are forced, for political reasons, to eschew the shares of the successful business and to choose those in a company which has obviously lost much of its original profitability!

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The market price of a share diverges from that share's nominal value because the real value of the business is rising or falling. If the real value is rising, that is almost certainly because the directors are ploughing back profits into the business. The new assets bought with these undistributed profits may be expected to earn still further profits, and so the real value of the business may get further and further away from the nominal value. The only way in which directors can keep the nominal value of a company's capital approximately in line with the real worth of the business is by issuing new shares to shareholders, either as "free" shares, or at a price greatly below the market price. These shares are known as "bonus" shares where a "free" issue is made; and the issue is described as being made "on bonus terms", where shareholders are required to put up *some* money.

Bonuses—and No Par Value Shares

THESE operations also create confusion, even among those who should know better. Obviously, there is no real difference between a company having 100,000 £1 shares earning 20 per cent and paying 10 per cent on those shares, and a company having 200,000 £1 shares earning 10 per cent and paying 5 per cent. Yet if a company in the situation of the first example announced a "free bonus" (or "scrip bonus" as it is sometimes called) of 100 per cent, or share for share, the odds are that its shares would rise, at least temporarily. This may be because its directors would feel less inhibited about paying 6 per cent on a nominal capital of £200,000 than they would about paying 12 per cent on a nominal capital of £100,000. (This is the old political factor again.) But in fact, it is clear that the mere act of creating more pieces of paper (which is what a "free bonus" amounts to) cannot of itself in any way affect the earning power or the asset value of the business. Similarly, in the case of an issue "on bonus terms", shareholders are in fact "giving themselves a bonus". As the result of the operation, they put up more money and have more shares. But provided they all subscribe to the shares to which they are entitled, their proportionate shares in the business are unchanged. The price at which the issue "on bonus terms" is made is really immaterial. If the price is low, obviously more shares will have to be issued to secure a given amount than if the price is high. But it makes no difference to the intrinsic value of the business whether the price is high or low.

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Nevertheless, although bonus issues mean practically nothing in real terms, they are a great convenience, given the insistence of the British company law on fixed nominal values for shares. A man may start his own business with a capital of £1,000 in £1 shares. He may build it up, by ploughing back profits, until after a lifetime's work and risk-taking, its value is, say, £250,000. Yet maybe because he and his family owned all the shares, he has never bothered to alter the original capital. Why should he? If later, however, he decides to sell all or part of that business to the public, it is obviously desirable that the nominal amount of the capital should approximate to the real worth of the business. Normally, this objective would be achieved by the simple process of making a "free bonus" issue. But in recent years, such issues, and also issues "on bonus terms", have been subject to a 10 per cent bonus duty (abolished in the 1949-50 Budget) the cost of which was so heavy as to be almost prohibitive. The result has been that companies' nominal capitals have got further and further out of line with reality. It was literally impossible to find a rational justification for this bonus duty. The general consensus of opinion is that it was inspired by a desire to embarrass politically those companies whose real capital was much above the nominal amount and thus to restrain them in their dividend payments. But since, at the time of writing, industry is operating under a voluntary dividend limitation scheme, even this flimsy "justification" had disappeared.

All this pother about nominal share values and "high" percentage dividends could be obviated if we adopted the "no par value" share. This share is exactly what its description implies; it has no par or nominal value and simply represents a fractional interest in the equity of a company. Obviously, since it has no nominal value, a dividend on a no par value share is not expressed as so much per cent, but as an amount, in money, per share. THE INVESTORS' CHRONICLE has for years campaigned for the no par value share, realizing that as politics intruded more and more in the world of company finance so would fixed nominal values become more and more troublesome. It looked as though the obvious case for the no par value share might be accepted when it was known that the Cohen Committee on Company Law Amendment, appointed in 1944, would consider the desirability of the reform. But the conservatism of "the City" and the professions prevailed, and the Cohen Committee reported that although there was much logic in the case for no par value shares, there was too much opposition to it. It is a reasonable presumption

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that those who opposed the reform in 1944 have, since July 1945, regretted their action. Incidentally, the no par value share is common form in the United States, and insofar as London deals in American shares it is quite familiar with no par value shares.

Gearing of Capital

“CAPITAL GEARING” is a matter which has a vital influence on the earning power of Ordinary shares. It is a term employed in connection with the composition of a company’s nominal capital as between prior charges—Debentures, Preference shares, etc., entitled to a fixed remuneration—and equity shares, whether described as Ordinary or Deferred or by some other name, whose dividend is entirely dependent upon the course of profits and the discretion of the directors. In bad years a heavy weight of prior charge interest and dividend may impose a severe strain and leave the equity shareholders high and dry. But in good years the surplus over prior charge requirements, being attributable to an equity capital that represents only a small part of total capitalization, can be very important when expressed as percentage earnings on that class.

Imagine a company with a capital of £100,000, all in £1 Ordinary shares, earning £10,000 a year after deducting profits tax, or 10 per cent. Now imagine that this company converts £80,000 of its capital into £1 4 per cent Preference shares, leaving only £20,000 Ordinary capital in £1 shares. Of the same earnings of £10,000, the dividend on the Preference capital will require £3,200, leaving £6,800 available for the £20,000 of Ordinary capital. This equals 34 per cent, in place of the original 10 per cent, on the Ordinary, and allowing for the fact that a high geared Ordinary share generally gives a more generous yield (if investors think profits are somewhere near their peak), the £20,000 Ordinary shares in their highly geared form might sell at, say, £4 each, to yield $8\frac{1}{2}$ per cent, whereas before the introduction of the gearing element described the £100,000 Ordinary shares might have sold at, say, £2, to yield 5 per cent.

Thus we see that high gearing of capital may exaggerate earnings available for the equity, and cause that equity to command a higher price on the market. The process, however, has its disadvantages at times, for if earnings are declining, then high gearing exaggerates the decline. The position can best be illustrated by giving examples of high-gearred, medium-gearred, and low-gearred companies with three profit levels in each case.

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		High - Geared Co.	Medium - Geared Co.	Low-Geared Co.
4% Preference ...	...	£80,000	£50,000	£20,000
Ordinary ...	...	20,000	50,000	80,000
		Profits of £5,000 p.a.		
Pref. dividend takes ...	...	3,200	2,000	800
Earnings for Ord. ...	...	1,800	3,000	4,200
" " %	...	9	6	5.25
		Profits of £10,000 p.a.		
Pref. dividend takes ...	...	3,200	2,000	800
Earnings for Ord. ...	...	6,800	8,000	9,200
" " %	...	34	16	11.5
		Profits of £20,000 p.a.		
Pref. dividend takes ...	...	3,200	2,000	800
Earnings for Ord. ...	...	16,800	18,000	19,200
" " %	...	84	36	24

It will be seen that doubled profits (from £10,000 to £20,000) increase equity earnings on the low-g geared equity only from $11\frac{1}{2}$ to 24 per cent, whereas with the medium-g geared company such an increase will increase equity earnings $2\frac{1}{4}$ times, and with the high-g geared company the same profit increase raises earnings on the equity by nearly $2\frac{1}{2}$ times. On the other hand, a halving of profits (from £10,000 to £5,000) cuts earnings on the high-g geared equity by nearly three-quarters, and on the medium-g geared equity by five-eighths, but reduces earnings on the low-g geared equity by little more than half. And, of course, if there is no gearing at all—i.e., if there is no prior charge capital—equity earnings are the same as total earnings, and on the profit levels given are exactly doubled or halved with total earnings.

These exaggerations of earnings, either way, by gearing, explain why the more highly geared is a company's capital the more volatile are its shares. They also explain why highly geared Ordinary shares are popular when profits are rising, but are dangerous holdings if profits turn downwards. Equally, they explain why the staid investor, the investor who is primarily concerned with a steady income, will stipulate that, for example, at least 50 per cent of a company's total capital must be in Ordinary shares. Or, if he is really up-to-date, he will insist that the "priority percentages" represented by the Debentures and Preference shares do not absorb an undue proportion of each year's net income.

Priority Percentages

To gauge the earning power and investment status of the various classes of securities discussed in this chapter, the most satisfactory instrument is the calculation called a "priority percentage".

STOCKS AND SHARES

Newcomers to investment matters may think the term "priority percentages" as difficult to fathom as the problems associated with differential calculus. A usual, though often misleading, way of calculating dividend or interest cover is the "times covered" method. Imagine a company with, say, £100,000 5 per cent First Preference and £10,000 5 per cent Second Preference capital, earning £20,000 a year in profits. The First Preference requires £5,000 per annum, and is thus covered four times; this leaves £15,000 for the Second Preference issue, which requires only £500 per annum in interest. And so, on the "times covered" system, the Second Preference dividend would appear to be covered no less than 30 times, giving the illusion that the covering is much better than that for the senior issue. A better method is to unite the requirements of both issues before assessing the "times covered" of the second issue; the combined demands of the case in point would thus be covered 3.6 times.

Under the more scientific priority percentage system, the dividend on the First Preference would be shown as absorbing the first 25 per cent of available earnings, that is, "0-25"; and the Second Preference as absorbing the next $2\frac{1}{2}$ per cent of available earnings, or "25-27 $\frac{1}{2}$ ". It can thus be seen that earnings could fall to 27 $\frac{1}{2}$ per cent of their former level without uncovering the Second Preference dividend and to 25 per cent without uncovering the First Preference. This system avoids the anomalies outlined in the previous paragraph, and gives the investor a clear-cut idea of what the dividend cover in each case amounts to in reality. It is particularly valuable when it is desired to compare the cover for prior charges of companies closely resembling each other or all falling, for example, within the same industrial group. It is, of course, essential with any method to be certain that the available earnings have been struck after deducting all obligatory charges—and it has not been unknown for company accounts to be so framed as to leave room for doubt as to whether some charges really are obligatory or optional. The present profits tax is also a complication which affects priority percentage calculations, since that tax is payable not only on all profits whether distributed or not, but also (and at a higher rate) on moneys paid out as Preference and Ordinary dividends, but not as Debenture interest. The consequential adjustments needed when working out priority percentages are, however, so complicated, and the effects often so small, that we shall content ourselves with mentioning the difficulty and with hoping that the abolition of profits tax will soon make even mention superfluous!

CHAPTER II

THE YIELD ON CAPITAL

Importance of yield calculations—Flat yields and redemption yields—Accrued interest—Modes of calculation—Adjusting “tax-free” dividends—The redemption factor—Yields on overseas issues—Sinking funds: ordinary and cumulative—Drawings for redemption—Average life and average yield of bonds.

NOWADAYS, we are told, investors are not interested in income; all they care about is capital appreciation. Yet the first question asked by nine investors out of ten, when considering an investment, is: “What does it yield?” Is this inconsistency on the investor’s part? No. However keen on capital appreciation he may be, however much he may appear to belittle current income, in fact every investor, perhaps subconsciously, buys a security for what it will yield now, *and in the future*. Expectations of capital appreciation are, in short, based on expectations of yield. It is difficult in the case of, say, an Orange Free State gold share to estimate expectations of future income. But deep down, and however approximately, “the market” even in such shares is governed by its guess of future yields.

It follows that yields and their calculation are vital to the investment process. That is not to say that, except for institutional investors where the last penny really matters and where yields are scientifically calculated, there is merit in the calculation of yields to several places of decimals. Such procedure is justified when a firm price is known, and when exact allowance is made for accrued interest or dividend and expenses. But when the calculation is rough and ready the first place of decimals, or fractions of not less than an eighth, or the nearest shilling will serve well enough.

Before we start describing the mechanics of yield calculation, we had better get our definitions right. First, what is a yield? It is the amount of income an investment will produce per annum, expressed for convenience as a percentage and almost invariably gross. Thus, if we say a share yields 4.8 per cent, we mean that if we spend £100 buying those shares—whether their price be 5s., 50s., or £5—that £100 will produce an income of £4 16s.; if we spend £200, our *income* will be £9 12s. Of such income, we may

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have to pay over to the Inland Revenue 9s. in the £, so the yield is called *gross*. If we express it as a *net* yield, 4.8 per cent gross becomes over 2.6 per cent, or £2 13s. It is customary to express yields gross because the tax status of investors varies: some may pay no tax, some may pay 19s. 6d. in the £. "Gross" provides a common measure which individuals can scale down, if necessary, to suit their own circumstances. Sometimes, alas, one sees lists of yields in which gross and net figures are intermingled as apparently comparable. This is bad, comparing like with unlike.

There are two types of yield. First, there is the "flat yield", which is also sometimes known as the current or running yield. This is the yield shown on all irredeemable dividend or interest paying securities, be they irredeemable Debentures, Preference shares, or Ordinaries. It is also customary to calculate a flat yield on redeemable stocks. But—and this is where the second type of yield comes in—with a redeemable stock, a "redemption yield" must also be shown. A redemption yield is necessary because the flat, or running, yield may be supplemented or reduced by a profit or loss on redemption. If, say, a 4 per cent Debenture is standing at 100 and is redeemable at 100, then obviously there is no profit or loss on redemption and the flat yield and the redemption yield will be the same at 4 per cent gross.

But if the same Debenture stood at 95 there would be a profit of 5 points on redemption, to be allowed for in calculating the redemption yield. Equally, if the Debentures stood at 105, there would be a loss of 5 points on redemption which has to be amortized and allowed for in calculating the redemption.

Before a yield can be calculated, one preliminary operation is necessary—the calculation of a "clean price", the deduction of the accrued interest or dividend from the price quoted or paid. There should also be added the expenses of the transaction, but few private investors bother about either sum. However, for the sake of completeness, we had better describe why and how a "clean price" is calculated. Its calculation is necessary because if you buy a security the last interest on which fell due say, four months ago, interest or dividend accumulated meantime is included in the price. To get at the real price of the security itself, therefore, this accrued interest or dividend has to be subtracted.

Calculating "Accrued"

CALCULATION of accrued interest or dividend is a simple matter. If a fixed interest security bears interest at 6 per cent per annum,

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the monthly rate is $\frac{1}{2}$ per cent. If there are four months' accrued interest in the price, therefore, the accrued interest amounts to 2 per cent. This is a gross sum, and, except in the case of the non-taxpaying investor, the appropriate amount of tax should be deducted; in the case in point, for the standard income-tax payer, the tax would be 18s., or 0.9 per cent, leaving the actual net amount to be deducted from the price as 1.1 per cent.

Where an Ordinary share is concerned, the amount of accrued dividend is inevitably a matter of estimation, for there is no certainty or fixity about Ordinary share dividends. But, provided the company has a fairly steady dividend record, it is generally safe to assume, for this purpose, that the previous year's appropriate rate (interim and final, or one lump payment) will be repeated. With the accrued interest or dividend deducted, and with the expenses (commission, stamp duty, etc.) added, we are all set to calculate our yield.

To calculate a yield is really to work a proportion sum. Where the interest on a perpetual Debenture is 4 per cent—i.e., £4 for each £100 of stock—our yield is 4 per cent if we pay £100 for the stock. If we pay only 50 our yield—i.e., our income per £100 of money we lay out—is 8 per cent, for £100 will buy £200 nominal of the stock, on which the income will be £8. If we pay 200 our yield will be 2 per cent, for each £100 invested will buy only £50 of stock, on which the income is £2. Suppose we pay 118 net, i.e., after allowing for accrued interest and expenses. In that event an outlay of £100 will buy $\pounds \frac{100}{118}$ of stock, the income from which will be $\frac{100}{118}$ of £4, or £3 8s. Our sum, then, shows that par value multiplied by interest rate and divided by price gives the yield per cent. Let us state this as an arithmetical formula:—

$$\frac{\text{Par} \times \text{Interest Rate}}{\text{Price}} = \text{Yield}\%$$

Examples—

(a) $5\frac{1}{2}\%$ stock at 137

$$\text{Yield} = \frac{100 \times 5\frac{1}{2}}{137} = \frac{1100}{274} = 4\%$$

(b) $5\frac{1}{2}\%$ stock at 63

$$\text{Yield} = \frac{100 \times 5\frac{1}{2}}{63} = \frac{1100}{126} = 8\frac{3}{4}\%$$

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In practice it is easier to say: The interest rate is 5.5 per cent. Multiply by 100 equals 550. In example (a) divide by 137, in example (b) by 63.

Keeping the idea of a proportion sum in mind, similar reasoning applies to the calculation of yield on shares. Suppose a £1 share to be paying $3\frac{3}{4}$ per cent. If we invest £100 with the shares at par our income is £3 15s. If the shares cost 22s., however, an outlay of £100 will give us only $\frac{20}{22}$ of £100 nominal of shares, and our income will accordingly be only $\frac{20}{22}$ of £3 15s., or £3 8s. The fraction $\frac{20}{22}$ results, it will be seen, from dividing the par value of 20s. by the price of 22s., so our formula is:—

$$\frac{\text{Par} \times \text{Dividend Rate}}{\text{Price}} = \text{Yield \%}$$

Examples—

(a) £1 share paying 25% standing at $6\frac{1}{8}$

$$\text{Yield} = \frac{1 \times 25}{6\frac{1}{8}} = \frac{200}{49} = 4\frac{1}{8}\%$$

(b) 5s. share paying $12\frac{1}{2}\%$ standing at 22s. 3d.

$$\text{Yield} = \frac{5 \times 12\frac{1}{2}}{22\frac{1}{2}} = \frac{250}{89} = 2\frac{3}{4}\%$$

In (b) it is simpler to deal with the par value in shillings, in which case the price must also be dealt with in shillings. Where, as in (a), there is advantage in keeping to pounds, both the par value and the price must be considered in pounds. These examples illustrate the reasoning behind the method. In practice, it is better to say: With example (a) the interest rate is 25 per cent; multiply by 1; divide by 6.125. That is, just put 25 down on paper and divide by 6.125. With example (b), the interest rate multiplied by par is 62.5. Divide this by 22.25.

Yields on No Par Value Shares

It is possible to ignore the par value of a share altogether by working from the value of the dividend. If this is 9d. per share (equivalent to $3\frac{3}{4}$ per cent on a £1 share, $7\frac{1}{2}$ per cent on a 10s. share, and so on) and the share stands at 22s., we argue that an

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expenditure of 22s. gives us an income of three-quarters of a shilling, so an outlay of 100s. will give an income of

$$\frac{\frac{3}{4} \times 100}{22s.} = \frac{75}{22s.} = 3s. 4\frac{1}{2}d.;$$

in other words, the yield will be $3\frac{1}{2}$ per cent. The formula is:—

$$\frac{\text{Dividend (in pence, shillings or pounds)} \times 100}{\text{Price (in pence, shillings or pounds)}}$$

Examples—

(a) Share at 95s. paying 3s. 6d.

$$\text{Yield} = \frac{3\frac{1}{2} \times 100}{95} = \frac{700}{190} = 3.7\%$$

(b) Share at 17s. 6d. paying 1s. 6d.

$$\text{Yield} = \frac{1\frac{1}{2} \times 100}{17\frac{1}{2}} = \frac{300}{35} = 8.6\%$$

In practice one would deal with example (a) by dividing $3.5 \times 100 = 350$, by 95 and with example (b) by dividing $1.5 \times 100 = 150$, by 17.5. This method has a sweet simplicity where the dividend in pounds, shillings and pence is known or is easily recognizable—5 per cent on a £1 share is manifestly 1s.—but it has no advantage where it is necessary to do any real figuring to arrive at the amount of a dividend from its percentage rate. It is worth discussing, however, because it is the method to apply where the share in question has no par value—an interesting commentary on the alleged unpopularity of no par value shares, which, it is said, the British investor cannot understand.

In all such calculations a favourite method will be evolved, and once the investor becomes thoroughly familiar with it, the calculation will be merely the work of seconds. Particularly is this so if the investor is a slide-rule addict. It takes perhaps fifteen minutes to understand the workings of a slide-rule, or one of its several adaptations; the investment will subsequently be repaid a thousand-fold. Alternatively, books setting out flat-yield calculations at varying prices and yields can be purchased. The following is a sample line extracted from “Investment Tables for Perpetual Stocks”, by Herbert Johnson (Fredc. C. Mathieson and Sons).

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		STOCK PAYING 5½ PER CENT							
Prices	Return per cent	Prices	Return per cent	Prices	Return per cent	Prices	Return per cent	Prices	Return per cent
£	s. d.	£	s. d.	£	s. d.	£	s. d.	£	s. d.
120	4 15 10	130	4 8 6	140	4 2 2	150	3 16 8	165	3 9 8

The prices given are for stock. With shares, the price has to be decimalized as a percentage of its nominal value. Thus, the stock prices given above represent prices of 24s., 26s., 28s., 30s. and 33s. for shares with a nominal value of £1.

Where dividends are paid tax-free, the gross yield can be obtained either by grossing up the dividend first, or by working out a tax-free yield and grossing up that yield at the end of the calculation. To gross up tax-free dividends with tax at 9s. in the £, the tax-free rate is multiplied by 1.82. (The multiple is the relation the gross amount per £1—20s.—bears to the net—11s.—and is obtained by dividing 11s. into 20s.)

Allowing for Redemption

THE underlying principle involved in the calculation of a redemption yield is the same as that described when we dealt with flat yields. We are, in fact, still working out proportion sums. But with a redemption yield there is the complication that we are dealing with two factors at one and the same time. First, we are dealing with the flat or current yield which the investment shows. Secondly, we are dealing with the profit or loss which a purchase of the security to-day will involve when redemption occurs. Consider three stocks all repayable at 100 on the same date, say, in twenty years' time:—

- (a) A 4 per cent stock now standing at 80;
- (b) A 5 per cent stock now standing at 100;
- (c) A 6 per cent stock now standing at 120.

By applying the formula outlined previously, it is evident that each stock gives a flat or current yield of 5 per cent. But in twenty years' time, when redemption occurs, each stock will be worth 100, its redemption level. Thus, in addition to the 5 per cent flat yield provided by stock (a), the buyer at to-day's price will receive 20 points capital profit. With stock (b) there will be neither profit nor loss on redemption; in other words, in this case the flat and redemption yields are the same, 5 per cent. With stock (c), there will be a loss of 20 points on redemption, and this loss has to be amortized (or provided for) from the holder's flat or current income.

Now it is tempting to conclude that with stock (a) there will

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be an *addition* to the flat yield of 1 per cent per annum, and with stock (c) a deduction from the flat yield of the same annual amount, because there is with (a) a profit of 20 points, and with (c) a loss of 20 points accruing in each case over twenty years. On this reasoning, the redemption yield of (a) would be 6 per cent and on (c) 4 per cent. This, however, is an over-simplification because of the compound interest factor; because £20 payable twenty years hence is not the same thing as £1 payable each year for twenty years. Because of compound interest, less than 1 per cent per annum is needed at a given rate of interest to produce or provide for £20 in twenty years. In fact, the redemption yield on stock (a) is 5.7 per cent; on stock (b) it is 4.5 per cent.

How to Use Yield Tables

How are these figures arrived at? For practical purposes, by the use of what are known as "Redemption Yield Tables". There are many varieties of these tables, and they are quite easy to use. They are grouped in sections, covering a range of interest rates—say from $1\frac{1}{2}$ to 5 per cent in "steps" of $\frac{1}{4}$ per cent. (These are the "coupon", or interest rates on securities.) Under each interest rate will be found a mass of columns, each headed with a separate term of years and months—19-5, 14-3, 24-0, and so on. (In the examples cited, "19-5" is 19 years 5 months, "14-3," 14 years 3 months, "24-0," 24 years.) Under these headings will be found a very large range of prices, and opposite each price at one side of the page, generally in heavy black type, will be found the redemption yield.

Thus, to take the case of stock (a), we turn first to the appropriate interest (or coupon) rate—4 per cent. Under that section we turn to the appropriate term—20 years. Having found it, we run our finger down the prices until we find the one nearest our purchase price. And then, running our finger horizontally over the page, we discover the redemption yield. The following sample lines are taken from the pocket edition of "Monthly Bond Values", computed and compiled by the Financial Publishing Co., of Boston, and obtainable normally in London through George Routledge and Sons Ltd.

Redemption	YEARS AND MONTHS								4%
Yield	19-5	19-6	19-7	19-8	19-9	19-10	19-11	20-0	
5.45	82.76	82.72	82.67	82.63	82.59	82.55	82.51	82.47	
5.50	82.23	82.19	82.15	82.10	82.06	82.02	81.98	81.94	
5.60	81.20	81.16	81.11	81.07	81.02	80.98	80.94	80.90	
5.70	80.19	80.14	80.09	80.04	80.00	79.95	79.91	79.87	
• 5.75	79.68	79.64	79.59	79.54	79.49	79.45	79.40	79.36	

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With stock (a) it is the last column on the right we want—20 years. Our price is 80. The nearest price to it is 79.87, and carrying our finger horizontally along that “price line”, we find the redemption yield is 5.70 per cent, or £5 14s. per cent.

So much for the mere mechanics of redemption yield tables. It may, however, help readers if we explain what the various prices shown in the above table represent. Perhaps the simplest approach is to realize that in buying a bond we are buying the right to two things:—

- (I) The right to receive income payments for a number of years.
- (II) The right to receive a certain capital sum at the end of that number of years.

The price paid for the bond is really the present value of those two rights calculated (or discounted), so as to give a particular yield on the sum invested.

Let us use as an illustration one of the prices shown in the above table under the twenty-year column, viz., 81.94. This is the price at which a 4 per cent bond with a life of twenty years will yield $5\frac{1}{2}$ per cent. What we are calculating is what we shall have to pay, assuming we want a yield or return of $5\frac{1}{2}$ per cent, in order to receive:—

- (I) Forty semi-annual payments of £2 (since interest is normally paid twice a year there will be forty payments in twenty years).
- (II) £100 at the end of twenty years.

If we turn to the compound interest tables we find already calculated at different yield rates the present value of the right to receive £1 per period and also the present value of the right to receive £1 at the end of the period. In our example we are assuming a yield rate of $5\frac{1}{2}$ per cent per annum or, as interest is received semi-annually, $2\frac{3}{4}$ per cent semi-annually. Under the $2\frac{3}{4}$ per cent table we find that the present value of £1 for forty periods of half a year is £24.078, so that the present value of £2 is obviously

$$2 \times 24.078 \dots\dots\dots = 48.16$$

We then find the present value of the £1 at the end of forty periods of six months each (that is, twenty years); this is £0.3378, so that the present value of £100 is

$$£100 \times 0.3378 \dots\dots\dots = 33.78$$

Giving the price for the bond of	81.94

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Redemption at Premium or Discount

ALL the yield calculations in such tables are, of course, calculated on the assumption that the stock is redeemable at 100. A complication may arise, however, if the stock is redeemable at more or less than 100, as is not infrequently the case. Here is the formula to meet such cases:—

A.—Divide coupon (or interest rate) by redemption price to get new coupon rate.

B.—Divide market price by redemption price to get new price.

C.—Find redemption yield at new price at coupon rate in tables nearest to new coupon.

D.—Add or subtract the difference between new coupon and the rate used in the tables (table rate lower, add; higher, subtract).

Example.— $4\frac{1}{2}\%$ stock, standing at 111, redeemable in 4 years at 105.

A.— $4\frac{1}{2} \div 105 = 4.29\%$ new coupon rate.

B.— $111 \div 105 = 105.71$ new price.

C.—Yield on $4\frac{1}{4}\%$ stock at 105.71 is.....2.73%

D.— $4.29 - 4.25$ is .04 to be added..... .04

Yield is.....2.77%

The Tax Factor

THE income tax (and surtax) factor is a vital matter in redemption yields. The factor arises because while the flat (or current) yield is subject to tax in the hands of most investors, a capital profit is mostly free of tax, and a capital loss has to be amortized from the taxed flat (or current) yield.

Thus, if we get a combination of low flat (or current) yield, a sizeable loss on redemption and a heavy rate of tax, it may be impossible to amortize the loss on redemption from the current income from the investment. In these circumstances, what is known as the “net redemption yield” (the yield after allowing for tax and loss on redemption) may be a *minus* quantity. So far from the investment yielding any income *over the whole of its life* it yields a loss. The most common case of this these days is to be found among stocks which represent a relic of the old days of dear money. You may have, for example, a 5 per cent issue redeemable at par in ten years, standing at 125. The stock stands so high because it is attractive to the non-tax-paying investor (a

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pension fund, or possibly a resident overseas). But to the investor paying tax, particularly in the higher ranges of surtax, such a stock is rank poison (although doubtless many such investors continue to hold these issues in ignorance).

For redemption yield purposes, indeed, the same stock in practice becomes different issues according to the tax status of the holder. Thus 4 per cent Funding, 1960-90, is really only a 4 per cent issue to the non-tax-paying holder. The investor paying income tax at 9s. should scale down the coupon rate accordingly, and regard the issue, for yield calculation purposes, as one bearing interest at £2 4s. per cent (£4 per cent, less tax at 9s.).

Where a stock with two redemption dates (such as 4 per cent Funding, 1960-90) stands at a premium in the market over the redemption price, the "life" of the stock should be assumed to be governed by the earliest redemption date (i.e., 1960, in the case in question), and the redemption yield worked out on this basis. But if the market price is below the redemption price, the "life" is taken to be that represented by the "far" date (i.e., 1990, in the case of Funding Loan). This is because one must assume that if the stock is at a premium the borrower will repay it as soon as possible; if it is at a discount, it will be allowed to run as long as possible because it would cost more in interest to replace.

There are other snags in yield calculations against which the newcomer should be warned. (Indeed, it is not only the newcomer who needs warning; sometimes these snags are overlooked by professionals.) We refer, in particular, to the necessity of ensuring that the interest or dividend is measured in the same currency as the price of the security. The London market is in the habit, for example, of using a "mock dollar", at a rate of five to the £, for quoting the price in London of dollar securities. To calculate a yield from a price expressed in "mock dollars", and a dividend or interest payment expressed in U.S. or Canadian dollars at a rate of 4.03 to the £, would clearly be misleading. In the case of a stock paying 5 per cent, and standing in London at 110, the yield is not

$$\frac{5 \times 100}{110} = 4.6\%$$

as might appear at first sight, but

$$\frac{5 \times 100}{110} \times \frac{5}{4.03} = 5.7\%$$

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Moreover, if the stock was repayable at (U.S.) \$100, there would not be a loss on redemption on the London price of 110, as, again, first impressions suggest. Either the U.S. redemption price must be converted to "mock" dollars (giving a redemption price, London terms, of 124); or the London market price must be converted into U.S. dollars, in which case it becomes 88½. Having got the factors in the equation in common form, the redemption yield can then be ascertained in the manner already described.

This question of making sure that we are using comparable items also arises in connection with Canadian and Australian securities. With Australian securities, it has to be remembered that the Australian pound stands at a discount in relation to United Kingdom pounds (£100=£A125). Unless allowance is made for this discount, calculation of a yield from a U.K. sterling price and a dividend in Australian pounds will result in the yield being over-stated. Dominion tax relief does not bulk so large in yield adjustments as it did before tax arrangements were altered when the war was ending; but it still has to be allowed for, mainly in connection with certain Canadian, South African and Australian securities. Yields on such issues are often appreciably higher than appears likely at first sight, but each case must be considered individually.

How Sinking Funds Work

WITH the issue of a redeemable security it is the general practice to make provision for its repayment by means of a sinking fund. Under a sinking fund a certain sum is set aside each year which, in total, will be sufficient to repay the loan on or by the redemption date. If repayment is to be made in full on a fixed date, the sinking fund will have no bearing on the yield offered by the security. But the sinking fund may be used to make repayments annually instead of at the end of a period, in which case the operation of the fund has a material effect on the yield, and before we can make any calculation of the latter we require to know, in addition to the bond rate, price and life of the security, the amount of the sinking fund and whether it is cumulative or not.

First of all, let us explain the difference between an ordinary sinking fund and a cumulative sinking fund. An ordinary sinking fund is one where a fixed sum, usually expressed as a percentage of the original amount of stock issued, is applied annually in

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repayment of the stock. The amount of stock outstanding is reduced with each annual repayment, which naturally decreases the total amount of interest to be paid to the stockholders, so that each year the service of the loan, that is, the annual capital repayment plus interest, is reduced by the amount of interest saved by the repayments.

For example, a £1,000,000 4 per cent Debenture stock repayable by a 10 per cent sinking fund, applied annually, would be repaid in ten years. At the end of the first year the stock's service would comprise a capital repayment of £100,000, plus £40,000 interest. But at the end of the second year, while the capital repayment is again £100,000, the amount of stock having been reduced to £900,000 by the first repayment, the interest to be paid is only £36,000. So it goes on until at the end of the tenth year the loan is repaid by a final payment of £100,000 plus interest of only £4,000. Actually, very few Debentures are issued nowadays on these terms of repayment, and it will be appreciated that from the borrowers' point of view it is preferable that repayment be made by equal instalments, in total, of capital and interest. This is where the cumulative sinking fund comes in.

A cumulative sinking fund is also usually expressed as a percentage of the amount of stock issued, but only in the first year does the instalment of capital repayment amount to such percentage of the stock issued. The second instalment is increased by the amount of interest saved by the repayment of the first instalment, and the third instalment is further increased by the interest saved on the first two instalments, and so on until the loan is repaid.

A Cumulative Fund in Action

Now, in the example given above, had repayment been by a 10 per cent cumulative sinking fund, the first capital repayment would be £100,000 and the first interest payment £40,000, as with a non-cumulative fund. But in the second year, the capital repayment would be £100,000 plus the interest saved on the £100,000 repaid in the first year, i.e., £4,000, making £104,000 in all, while the interest on the balance of £900,000 stock outstanding would only require £36,000, making a total payment of £140,000, the same as the first year. At the end of the third year the capital repayment would be £100,000, plus the interest saved on the £204,000 of capital repaid, i.e., £8,160, making £108,160 in all, and the interest on the balance of £796,000 stock

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outstanding would require £31,840, again making a total payment of £140,000. And so we proceed to the final repayment. In fine, in addition to the 10 per cent sinking fund, the cumulated or compound interest saved on the repayments each year is applied to repayment of capital, and thus we get what is known as a cumulative sinking fund. It will be seen that repayment on this basis will be made sooner than by an ordinary sinking fund.

By dividing the percentage of an ordinary sinking fund into 100 per cent, we can easily ascertain the life of a security (10 per cent equals ten years, 5 per cent equals twenty years, etc.). With a cumulative sinking fund it is not quite such an easy matter, but our task is greatly simplified by the use of compound interest tables in which is given, in tabular form, the amount of an annual payment of "one" accumulated at compound interest at various rates for a given number of years. These tables usually go up to a period of 100 years and to about eight decimal places, and the following is an extract from such a table up to ten years but only to four decimal places.

AMOUNT OF 1 PER ANNUM

(i.e., the amount of an annual payment of 1 accumulated at compound interest)

	3½%	3¾%	3½%	3½%	4%
Years	Amount	Amount	Amount	Amount	Amount
1	1.	1.	1.	1.	1.
2	2.035	2.0362	2.0375	2.0387	2.04
3	3.1062	3.1100	3.1139	3.1177	3.1216
4	4.2149	4.2228	4.2306	4.2385	4.2464
5	5.3624	5.3758	5.3893	5.4028	5.4163
6	6.5501	6.5707	6.5914	6.6121	6.6329
7	7.7794	7.8089	7.8386	7.8683	7.8982
8	9.0516	9.0920	9.1325	9.1732	9.2142
9	10.3684	10.4216	10.4750	10.5287	10.5827
10	11.7313	11.7993	11.8678	11.9367	12.0061

At the head of each column is shown a bond rate, and the index figures below give the total amount of an annual payment of "one", *made at the end of each year*, compounded at the rate in question for the number of years shown in the first column on the same line as the index. To obtain the amount of the cumulative sinking fund for any one year, we first ascertain the amount to the required year and deduct from it the amount to the previous year. As an example, let us check the amount of £108,160 which we ascertained earlier would be repaid in the third year of a cumulative sinking fund of £100,000 at 4 per cent. From the 4 per cent tables we find that the index figure is 3.1216, from

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which we deduct the index figure of 2.04 for two years, leaving 1.0816 which, multiplied by £100,000, gives £108,160.

To find the cumulative sinking fund required to repay a certain sum in a given period, we turn up the tables at the rate of the bond in question, ascertain the index figure against the required term of years, and divide it into the amount of the loan. If the result is desired to be expressed as a percentage we simply divide the index figure into 100 per cent. Thus, to repay a 4 per cent loan in ten years would require a cumulative sinking fund of 100 per cent divided by 12.0061, which is $8\frac{1}{3}$ per cent.

Yields on Sinking Fund Issues

HAVING thus grappled with the intricacies of sinking funds, we can proceed to the calculation of yields on loans which are redeemable by periodic drawings, usually by annual drawings. Repayment of a Debenture or other prior charge may be made proportionately each year to all holders, but more often than not the question of which stockholders are to be repaid, and to what extent, is determined by "drawings". A drawing is no different in principle to the drawing of the Irish Sweep or any office or works football sweep, the "prize"—when the market price is below the redemption price—being the repayment of all or part of the holder's stock. There is, of course, not a "prize" but a "penalty" if the stock is standing at a premium and is repayable at par. To spread the risk and make it as fair as possible, drawings are usually made in lots not exceeding £1,000.

In broad outline, the method of drawing is to prepare a list of stockholders, in which all holdings of over £1,000 are split into lots of £1,000 and any fractions or holdings of less than £1,000 are lumped together to make up complete lots of £1,000. Each lot is then numbered, and discs with corresponding numbers are then placed in a bag and thoroughly mixed. Depending on the amount to be repaid, a relative number of discs are then drawn from the bag, and the holdings corresponding to the numbers on the discs are duly repaid. Mechanical devices to achieve the same end have been evolved.

As an alternative to repayment by drawings, it is usual for a borrower to reserve the right to apply the sinking fund to the purchase of stock on the open market, subject to the price of the stock not being above par. Such an option is a distinct advantage if the stock is priced below par, as it obviously enables the borrower to buy in more stock than he could otherwise have

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repaid by drawings at par. If stock subject to such option is below par, the yield is calculated in the normal way to the redemption date as, in theory, the stock will not be subject to compulsory repayment by drawings.

With stock standing at a premium the repayment of capital over a period, either by fixed payments or by drawings, will obviously affect the yield, as such stock which is repaid in the first year will yield less than that repaid in the last year or during the interim. Our problem then is to calculate a yield which will allow for annual repayments of capital; that is to say, we must find the "average yield". With any redemption yield the governing factor, apart from the price, is the total income available during the life of the security.

Where stock is to be repaid in fixed equal amounts proportionately to all holders, this is a relatively simple matter to ascertain. For example, let us take a 4 per cent Bond, price 108, repayable in ten years by instalments of 10 per cent. At the end of the first year, interest will be £4 gross on a £100 nominal capital, but at the end of the second year it will only be £3.6 gross on a reduced capital of £90, and so on until in the tenth and last year interest will only be £0.4 gross on a capital of £10. The average income over ten years is, therefore, $\frac{£4 + £0.4}{2} = £2.2$, and

the total income for ten years is £22 gross. With a "firm" holding (that is, a bond held as a permanent investment), £22 gross can be earned at 4 per cent in $5\frac{1}{2}$ years, so that the average life of the security is $5\frac{1}{2}$ years, and a redemption yield calculated for this period will give us the average yield. The simplest and most obvious way of calculating the average life of a bond repayable by equal instalments is to add the first and last years together and divide by 2, e.g. $(1 + 10) \div 2 = 5\frac{1}{2}$ years.

Having obtained the average life, we proceed to calculate the yield from bond value tables in the normal way, as shown earlier in this chapter. In the present case, the yield of a bond carrying an interest rate of 44s. per cent net (i.e., our 4 per cent Bond, less tax at 9s.), priced at 108, and repayable in $5\frac{1}{2}$ years at par, is 15s. 3d. per cent net, which is the average yield of the required bond for ten years.

The Case of Victory Bonds

WHERE repayment is by drawings, the procedure to ascertain the yield is a little more complicated. The actual result of

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drawings on individual holdings cannot possibly be determined, and we can therefore only assume that individual experience will be in proportion to repayments on the whole issue. The classic example of a stock repayable solely by drawings is 4 per cent Victory Bonds, which were issued in 1919 for repayment over a period of fifty-six years by a $\frac{1}{2}$ per cent cumulative sinking fund. Here, again, we require to ascertain the average life to obtain the average yield. Before we can do this we must know exactly how much interest will be paid on a diminishing capital in fifty-six years. To start off with we know that a $\frac{1}{2}$ per cent cumulative sinking fund is made up each year of $\frac{1}{2}$ per cent plus the interest saved on the previous repayments of capital, so that at the end of fifty-six years the total repayment of 100 per cent must be made up of fifty-six times $\frac{1}{2}$ per cent, plus interest saved on the repayments. Interest saved is thus 100 per cent less 28 per cent (fifty-six times $\frac{1}{2}$ per cent), which is 72 per cent. With no capital repayments a £100 Bond could have earned £224 in fifty-six years at 4 per cent per annum, but being subject to repayments it could earn only £224 less £72=£152. A "firm" £100 bond could earn £152 at 4 per cent in thirty-eight years (i.e., $\frac{152}{4}=38$) so that the average life of 4 per cent Victory Bonds *at the time of issue* was thirty-eight years and the average yield would have been calculated then on that basis.

To bring the story up-to-date we must make similar calculations but adjusted to suit the new circumstances. Of course, the method of calculating the yield remains unaltered but, naturally, the average life changes from day to day, although for all practical purposes we need only work to the nearest month.

The average life can be calculated as at any day of the year, but during the period of from one drawing to the next the average life varies only by the time which has lapsed since the first drawing, so that there is only need to calculate the average life once a year, thereafter making due allowance for the passage of time until the next drawing is made.

The annual recalculation must be made after each drawing, which takes place about the end of June, but in practice it will be found simpler to calculate the average life as at 1st September and to add on the two months from the end of June. Why on that date? Because it is then that the drawn Bonds are repaid and it is also the last interest date for the preceding year, so that all Bonds in existence on 1st September, and each subsequent

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1st September, will earn one full year's interest for each drawing made, which simplifies our calculations by the elimination of a fractional interest earning period.

Let us then now proceed to the calculation of the present average life and so on to the yield. The last Victory Bond drawing was made at the end of June, 1948, for repayment on 1st September, 1948, so up to and including that date twenty-nine drawings have been made leaving twenty-seven more yet to be made (or rather twenty-six drawings and a final repayment, which amounts to the same thing) and interest to be earned over a similar number of years. From compound interest tables we find that the amount of a $\frac{1}{2}$ per cent cumulative sinking fund for twenty-nine years is 26.4831 per cent, so that the balance of Victory Bonds outstanding at the moment is 73.5169 per cent of the amount issued. Also from the tables we find that with the 1949 drawing a total of 28.0425 per cent will be repaid, so that in 1949 the amount repaid will be 28.0425 per cent minus 26.4831 per cent, which is 1.5594 per cent of the original amount issued. A purchase now will, therefore, be subject to drawings by a cumulative sinking fund of 1.5594 per cent of the original amount issued against a balance outstanding of only 73.5169 per cent. The effective cumulative sinking fund is therefore

$\frac{1.5594}{73.5169} \times 100 = 2.1211$ per cent, and the amount of stock repaid by interest saved on capital repayments will be 100 per cent less 57.2697 per cent (twenty-seven times 2.1211 per cent) which is 42.7303 per cent.

In a life of twenty-seven years a 4 per cent Bond, not subject to repayments, could earn 108 per cent, so that the total interest payable on Victory Bonds from 1st September, 1948, will be 108 per cent minus 42.7303 per cent, which is 65.2697 per cent, and this could be earned at 4 per cent per annum in 16.317 years or 16 years 4 months, which is the average life of Victory Bonds at 1st September, 1948. To adjust this to the present time (the end of March, 1949) is simply a matter of deducting seven months, i.e., the period from 1st September, 1948, which gives us an average life at time of writing of 15 years 9 months.

At a price of $115\frac{1}{2}$ a 4 per cent Bond, the interest on which, less tax at 9s., is worth 44s. per cent per annum, would yield £1 2s. 6d. per cent net to redemption, and this represents the average yield of 4 per cent Victory Bonds to the final redemption date after allowing for drawings.

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Here we would emphasize that *all* redemption yields must be calculated on a *net* income basis because of the varying income tax factor, while the average life of a Bond subject to drawings must be calculated on a total *gross* income basis, as neither the sinking fund nor the cumulative portion, which together make the cumulative sinking fund, are subject to tax.

To calculate the yield of a security redeemable by a cumulative sinking fund through drawings the prime object is to calculate the average life, and having explained the principles by which this is obtained we now sum up the whole method as a formula, which is as follows:—

$$\text{Life to final redemption} \quad \text{minus} \quad \left\{ \frac{100 \text{ minus (number of drawings to final redemption times effective S.F.)}}{\text{Interest rate}} \right\}$$

CHAPTER III

MANAGING THE GILT-EDGED MARKET

Cheap money nothing new—The Daltonian policy—Types of floating debt—Policy aided by Government Departments—The banking system's part—Composition of banking assets—Investors' position under liquidity—Vested interests in cheap money—Objections and dangers.

In the last two or three years there has been no lack of incident in the gilt-edged section of stock markets, and the small investor should have a working knowledge as to how a cheap money campaign is inaugurated and sustained. For fluctuations in the long-term rate of interest can have far-reaching effects throughout the investment world.

It is as well to understand at the outset that cheap money is no new phenomenon. Cheap money has been known, on and off, from time immemorial. But, before 1932, it was "natural" cheap money we knew. Money became cheap, or, more properly, the *price* of money (interest rates) became cheap when the demand for it fell below the supply, and interest rates were cut so that the supply could find what employment it could. In theory, at least, money eventually became so cheap that it was worth while for industrialists to borrow it, and thus cheap money became a factor in trade revival. When trade did revive, the demand for money increased until eventually money became so dear that its dearness damped borrowers' ardour and, among other things, stopped the boom.

From 1932 onwards, however, we have had engineered interest rates. (That is not to say that we might not, at times, have had cheaper money under a natural system than we have in fact had under control.) But there has been as great an advance in the cheap money philosophy between 1932 and 1949 as there was distinction between the cheap money era of the 1890's and the cheap money era of 1932. In 1890 money was cheap from completely natural causes. In 1932 money was made cheap, partly by natural causes (yields were falling well before the conversion of 5 per cent War Loan into its present $3\frac{1}{2}$ per cent form), and partly by deliberate intent. Looking back on that 1932 conversion, one's main impression, however, is one of

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astonishment that it was engineered with so few controls and in so free an economy: investors were virtually as free as the air to do what they liked with their money, inside and outside this country. Yet the operation succeeded.

In the years after World War II, money has been cheap when, by all natural laws, it should be dear. It has been cheap when saving is, relatively, unpopular; when people want to spend; when industry would gladly pay high interest rates if by doing so it could profit from the public desire to spend. It has been cheap only because of rigid controls and because most alternative avenues for using money, at home and abroad, are blocked. Mr. Dalton might boast of his achievements and put them on a parity with Lord Goschen's in the 1890's (Lord Goschen converted 3 per cent Consols into the present $2\frac{1}{2}$ per cent stock by two stages). Mr. Dalton might, by implication, boast that he surpassed the achievements of Lord Snowden and Mr. Chamberlain in 1932. But in reality he was comparing like with unlike. Cheap money to-day is entirely different from cheap money in earlier periods. Cheap money to-day, even if one accepts the thesis that it has merits, is wholly artificial and engineered.

How is it engineered? It is engineered, broadly speaking, in two ways, the direct and the indirect. In the direct way, the Government does its own work; in the indirect, it causes the banking system and the public to do its work for it. Directly, the Government is responsible for the investment of vast sums of money; and the more prosperous the country is, the greater the sums available. It is responsible, for example, for the investment of the funds of the Unemployment Fund (merged as from 5th July, 1948, in the National Insurance (Reserve) Fund) and the Post Office Savings Bank. By using these sums as and where it thinks they will do most good to its credit as reflected in Stock Exchange prices, the Government can help to reduce or sustain a given level of interest rates. But these direct market operations may not be sufficient—after all, the National Debt is more than £25,000 millions (of which about a half is quoted on the Stock Exchange), and even Mr. Dalton could hardly have digested such a meal if the banks, institutions and private investors decided to sell. So somehow a majority of these non-Governmental investors must be induced, at worst, not to sell; at best, to buy. But before we see how this willingness to play ball is induced, we must examine the stock-in-trade which the Government has to offer its varied customers in gilt-edged stocks; and we must also examine the

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resources of the customers, and their disposition, to see how they are willing and able to play ball.

Playing on the Floating Debt

Now investors may object that they know all the Government's wares—from a "short", like $1\frac{3}{4}$ per cent Exchequer Bonds, 1950, through the mediums, like the $2\frac{1}{2}$ per cent National War Bonds, 1954-56, to the longs (3 per cent Savings Bonds, 1965-75) and the irredeemables or one-way option stocks ($2\frac{1}{2}$ per cent Consols). But these are only half the Government's wares, comprising what is known as the "funded debt". There is another very substantial block of Government obligations, known as the "floating debt" because it is of a very short and fluid nature. And this floating debt plays a vital part in the management of gilt-edged securities.

It consists in the main to-day of two types of obligation, Treasury Bills and Treasury Deposit Receipts. Treasury Bills have a life of only three months, and such bills are only intended to provide temporary finance; to finance a current revenue deficit. They do not bear a positive rate of interest. One class of Treasury Bill, the tender bill, is tendered for the discount houses and other institutions each week, the institutions being in competition one with the other, and bills are subscribed for at a discount below their redemption price, the "profit" on redemption representing the interest. To-day, the Government borrows on Treasury Bills at approximately $\frac{1}{2}$ per cent per annum. The second class of Treasury Bill is known as the "tap bill", because it is issued whenever necessary through "the tap", at the rate of discount current for such obligations. These tap bills are subscribed for by special quarters of one kind and another, including the Public Departments and other Government bodies, and not forgetting the highly important overseas holders of the sterling balances accumulated during and after the war. Flanking the Treasury Bills are the Treasury Deposit Receipts, which have a life of six months and bear interest at $\frac{5}{8}$ per cent per annum. These are a war-time innovation and are held by the banks, who take them up in the amounts required by the Government.

In the old days, it was considered prudent finance not to raise the floating debt too high, but to fund it—to convert it into permanent debt with as long a life as possible—whenever opportunity arose. This was so mainly because Chancellors then felt uncomfortable with too much short-term debt about; in a crisis, they would have constantly recurring obligations to redeem, and

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it might be difficult (and expensive) to borrow new funds to meet those obligations; so far as the floating debt was held by foreigners, it might, in times of crises, be quite impossible to renew that portion. Present-day Chancellors seem less afraid of a high floating debt—and that is as well, for this portion of the National Debt has increased markedly in recent years, in large part, of course, as a result of the growth in sterling balances. And, of course, the whole banking mechanism to-day is so much part of the Governmental finance machine that many of the old dangers attaching to floating debt have disappeared.

How does this floating debt help the Chancellor to control the prices of the funded debt, however? The Government can use the funds at its command to support the gilt-edged market direct, by buying market securities. It taps the stream of funds flowing into, for example, the National Insurance (Reserve) Fund and the P.O. Savings Bank by allowing them to be invested direct in gilt-edged issues, or by issuing tap Treasuries against these funds. Even if the Treasury borrows thus against tap Treasuries, the process provides passive support for gilt-edged. The effective part of the floating debt, the part which makes funding desirable (even to-day), is the tender issue of Treasury Bills and T.D.R.'s, which represent amounts actually owing to the public. If the departments are taking up tap Treasuries, there is less need to borrow on tender bills, and indeed, the tender issue may be reduced (by offering fewer bills at the tender). In either event, the issue of a new long-term funding loan is postponed—and the threat of a new loan generally tends to depress or restrain the market.

When a new issue is necessary, the way can be prepared, if conditions are not too favourable, by preliminary market support from the departments. The departments may use their current receipts for this purpose, or they can allow some of their tap bills to run off, using the proceeds to buy gilt-edged. (The Treasury repays the tap bills by issuing more tender bills.) Alternatively, for some time before the new issue, the departments will invest their funds in tap bills. Then, when the time comes, and if the loan is not a public success, they exchange these bills for that portion of the new issue which is not publicly subscribed. Over a period, they release their holdings of the new security in such amounts as the market can stand. With the proceeds from the sales of the new security, they may buy tap Treasuries again, putting the Government in funds once more and permitting it to reduce the tender Treasury Bill issue or to keep it lower than

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would otherwise have been the case. The net result is that the public ultimately takes up the new loan—and without the rise in the yield basis of gilt-edged stocks which would otherwise have been unavoidable.

If it is not a new loan which is in question, but the conversion of a maturing loan, the technique is different, but the departments' aid is just as indispensable. In this case, the object (as with the important 3 per cent Local Loans redemption operation of 1946) is to prevent the maturing loan getting into the hands of those who will not convert, but will demand cash. To prevent this, the departments steadily buy up as much as possible of the outstanding issue in advance, and then apply for the new security when the conversion loan is issued, later gradually disposing of their holdings as circumstances permit, and then, if it suits their book, going back once more into tap Treasuries, and enabling the total of tender Treasuries to be kept down or reduced. Thus are "direct operations" financed.

How the Banks Help

THE next problem to consider is how the Government can support the market indirectly, by inducing the banks and the public to do its work for it. Let us start with the part the banking system plays. Consider first these figures, extracted from statistics published by the clearing banks in July, 1939:—

					£ mns.	% of
Clearing Bank Deposits					2,240	Deposits
Bank Assets						
Cash	...	...	...	...	235	10.5
Call Money	...	...	...	...	155	6.9
Bills discounted	...	...	...	...	278	12.4
Investments	...	...	...	...	597	26.6
Advances	...	...	...	...	982	43.8

Of the assets, it has to be noted that three items—call money, bills discounted and investments—which in 1939 totalled over £1,000 millions, represent in the main, directly or indirectly, Government obligations. These days, with the decline of the commercial bill (at any rate as compared with pre-war conditions), it is mainly Treasury bills which the banks discount (buy from holders at a discount before maturity); call money is lent to the discount market to enable the latter to hold Treasury bills or short-dated Government loans, or to Stock Exchange firms against other Government securities; and investments for the most part consist of direct obligations of the Government.

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We see, therefore, that anything which enables the banks to expand their combined holdings of these assets is equivalent to an additional demand for British Government obligations and tends to raise the price of such obligations.

The proportions which the various categories of bank assets bear to the deposits total provide the key to the manner in which this additional demand can be created. Here a complication arises. It used to be said that the crux of the matter was that cash represented approximately 10 per cent of deposits. "As the banks seldom or never allow this ratio to fall below 10 per cent (to provide assurance to depositors) and normally are unwilling that it should much exceed 10 per cent (to avoid the unprofitable use of resources)", the pundits would write, it could be demonstrated that an increase of £10 millions in the banks' holdings of cash tended to result in the creation of some £100 millions of additional deposits; the banks, having more cash, would lend more freely and buy more securities, and there is an old banking axiom that every advance creates a corresponding deposit somewhere in the banking system. (If a bank lends money to an intending house purchaser, the purchaser gets the advance and the seller the deposit.)

Has anything happened to upset the mechanics of the process described? Not really, but the old ideas about cash representing 10 per cent of deposits need to be revised somewhat. For the 10 per cent figure was something of an illusion, arrived at by the process known as "window-dressing", to make bank statements conform to the pattern the public expected. The 10 per cent figure was, in recent years at least, in most cases effective only on the day the statements were made up, and normally the banks were content to work on a level of cash equal to around 8 per cent of deposits. They agreed to abolish window-dressing at the end of 1946, and now an 8 per cent ratio is regularly seen. This change is mentioned mainly because instead of the tenfold expansion in deposits and non-cash assets which the 10 per cent ratio was held to permit, an 8 per cent cash ratio permits a $12\frac{1}{2}$ times expansion in deposits and non-cash assets.

But it is not all the non-cash assets which can be expanded. The supply of Treasury bills available for discount is controlled by the Government, not the banks; similarly, the upper limits of the amount of money lent to the discount market and the Stock Exchange are beyond the control of the banks. So far as advances are concerned, the banks maintain, on the one hand, that no sound borrower is ever refused accommodation, and on

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the other that an unsound borrower would not be accommodated whatever the level of the cash holding. Thus it is argued that industry itself (and not the banks) determines the level of advances. In short, the one type of asset which is within the control of the banks is their investments portfolio, and we thus reach the kernel of the matter. Any increase in the supply of bank cash tends to induce the banks to buy gilt-edged; any strain on their liquid position causes them to sell gilt-edged stocks.

You will ask, however, how the level of the banks' holdings of cash itself is determined. These cash holdings are in two parts. First, there is till money, the cash the banks hold to meet the needs of their customers. Secondly, there is the cash they keep at the "Bankers' Bank", the Bank of England. Assuming that there is no change in the demand for notes on the part of the public, to expand bank cash means increasing "bankers' deposits", which latter is the item in the Bank of England return under which the banks' cash holdings at the Bank appear. To increase bankers' deposits (i.e., the banks' cash) at the Bank of England, it is only necessary for the Banking Department of that institution to buy securities (either Treasury bills or longer-term Government loans), such purchases putting the banks in cash. If as a result the Bank's own cash ratio becomes strained, the proportion to its liabilities can be restored by an increase, authorized by the Treasury, in the fiduciary note circulation (which is that part of the Bank of England note circulation which is not covered by gold).

As a postscript, let us set out some post-war clearing bank figures (as at April, 1949), so that you can contrast them with the pre-war figures given above:—

					Million £	% of Deposits
Clearing Bank Deposits	...	...	...	...	5,886	—
Bank Assets :						
Cash ...	...	...	...	...	500	8.5
Call Money ...	...	...	...	...	480	8.1
Bills discounted	...	...	...	...	799	13.5
Treasury Deposit Receipts*	...	...	...	...	1,025	17.5
Investments ...	...	...	...	...	1,501	25.5
Advances ...	...	...	...	...	1,435	24.4

*These are a war-time innovation, as mentioned earlier in this chapter.

By no means all of the vast expansion is due to the authorities' policy of managed interest rates. In war-time, to the extent that the community is unable to save or suffer direct taxation of its income, the Government borrows from the banking system by creating I.O.U's, which the banks take up. But the figures do

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provide some explanation of why, with the National Debt increased from £8,301 millions in 1939 to more than £25,000 millions to-day, the authorities have been able not only to hold gilt-edged prices, but at times to push them to record levels.

“Conditioning” the Public

THE public—the other institutional and company investors and the private individual—must also play their part if the programme is to succeed. How is their assistance induced? No single answer is possible, for an amalgam of factors has to be at work. Let us set out some of them. Institutional help can be secured either by an “or else” attitude, or by the severe limitation of alternative avenues of investment. On the first count, for example, the British insurance industry during the war years undertook to invest all its *new* money in the tap Government loans. It also received a tax concession in the shape of a differential tax liability (7s. 6d. in the £) on income secured from its life fund investments. The two arrangements were not linked together, but who can doubt that certain thoughts were at the back of the minds of both parties? On the second count, the institutional investor often simply has to become and remain fully invested; he cannot stay “out of the market” and live on capital. If alternative investment avenues—and investment in this context may include physical investment (in ships, plant, buildings, etc.)—are absent he must buy either “old” securities already in existence or such new securities as *are* offered. By buying “old” securities he does nothing to relieve the general pressure of money (for whoever sells the “old” securities has the same re-investment problem), and merely pushes up the price and reduces the yield on these “old” securities. If the authorities see to it that offers of new securities are restricted, perhaps solely to Government securities, one of two things can happen. Either yields on “old” securities will be reduced to relatively unattractive levels, in which case the yield on Government obligations will “look” good and attract funds; or these funds will go straight into the new Government securities in the first place. In either case the Government’s cause is served.

Additionally, the Government, by the credit expansion process already described, can overcome a serious barrier to a reduction in interest rates, namely, what the economists call “liquidity preference”. In certain circumstances investors do not want to be invested, however attractive yields may be. (We saw this state of

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affairs very clearly in the crisis months of 1940.) All they want is to be liquid. And the Government's answer, in a managed, cheap money economy, is to give them what they want, namely, liquidity and still more liquidity, until investors are so well supplied with funds that they think they had better do something with them—namely, invest them. The Government expands bank cash. The banks can, in consequence, buy securities (thus satisfying the sellers' demand for liquidity). At the same time, the Government may starve the investing public of new investment facilities, borrowing on short-term the while, and thus, as it were, killing two birds with one stone—expanding the credit base and concentrating public demand on "old" securities. In the end, and particularly if there is pure inflationary borrowing going on, as there has to be in war-time, there is just so much money about that there is little point in sitting on it.

Psychological factors also play their part. If, for example, you can keep the carrot of capital appreciation, or the fear of still smaller interest returns in the future, dangling in front of the investor's nose, he is obviously going to play along with you. Stock Exchange prices are largely determined over the short run by the marginal dealings of the active professional. If you create a tax situation in which capital appreciation is highly desirable; if you openly proclaim (as Mr. Dalton did on several occasions) that gilt-edged are going up and up; if it is possible to buy large lines of stock by putting up only a 5 per cent margin (as professionals can, and do, even in these days), then it is obvious that the active professional is going to take advantage of such conditions. And then, hey presto, almost overnight a new issue whose terms looked too high is made to look "right". A new step in the cheap money campaign has been taken, and the gain can in due course be consolidated by the other means already described.

It must also be remembered that cheap money of itself creates an enormous vested interest in cheap money. The process in time affects all security values, and when all investors are to some degree converted into speculators by high taxation, they are by no means wholly averse to falling yields if they get tax-free capital appreciation at the same time. Equally, dear or dearer money means deflated capital values. And no investor, be he private individual or institution, can be expected to be enthusiastic about capital losses!

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Benefits—and Dangers

It remains to discuss the dangers of and objections to the policy we have outlined. First, however, we should be clear about the benefits of cheap money. They are fairly obvious.

Dear money—the burden of the National Debt before 1932, for example—means that in framing his annual Budget a Chancellor of the Exchequer may not be able to carry taxation relief as far as he would if the debt service absorbed less. A low rate of interest on the Government debt means reduced rates for other borrowers. And such reduced rates may encourage these borrowers to proceed with work-making projects which might otherwise lie in cold storage. This argument cannot be carried too far. If an industrialist believes he has a real money-spinning project, he will not boggle at paying an extra 2 per cent on the money involved. But there are some investments, generally long-term capital works, where a saving of $\frac{1}{2}$ or 1 per cent on the money may make all the difference between ultimate profitability and loss. And on a housing programme, too, a fall in the interest charge is not only politically attractive; it does perform a social service in keeping down a large item in working-class budgets.

Few people to-day would argue for deliberate dear money. What are the objections to and dangers of cheap money to offset its benefits? Investors will, very naturally, think of the obvious disadvantages of lower purchasing power. This applies particularly to the class known as *rentiers* (who are, properly speaking, people living exclusively on the revenue from fixed-interest securities). Some investors' objections can be classed, perhaps, as special pleading. But it is a valid objection to an ultra-cheap money policy that it does cause hardship to provident folk, and does upset long-standing arrangements (trusts and payments to the clergy, etc.). It makes savings and insurance provisions inadequate. It may, even in this specialized aspect, have inflationary consequences; if the assumptions on which a pension fund is based are upset, for example, the ultimate remedy is higher contributions, and these will almost certainly lead to claims for higher wages by those affected, or to an attempt on the employer's part to pass on the increased cost.

But the main objections to an ultra-cheap money policy in to-day's conditions are economic. When trade is slack, the nation's savings are not being fully employed and anything which brings them into employment is good. But when trade is good, the community's savings are being fully employed on capital

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projects. The people must save to-day simply because by saving they do not spend; saving is not wanted to finance an industrial machine already operating at full stretch. When trade is good, moreover, then obviously the pressure to spend is increased without any corresponding growth in the supply of goods. And that pressure means pressure on the prices of goods.

To combat these pressures, the Government must impose and maintain rigorous physical controls—rationing, price controls, licences, and the like. Despite such controls, the glut of money, high taxation and the smallness of the incentive to save tend to encourage black markets, particularly when the patriotic restraints of actual war conditions are removed. And if that sort of thing gets out of hand, there is an obvious danger of runaway inflation and a general crisis of confidence. Given such a threat, the need for the controls is self-evident. Yet the controls are poor respecters of persons in practice. They *may* check the black marketeer; but equally there is a danger that they will check or hinder legitimate business enterprise.

One final objection to an ultra-cheap money policy in a time of full employment may be mentioned. Variations in interest rates are *one* weapon (there are many others) in preventing trade activity from reaching either undesirable heights or unwanted depths. But if the authorities force interest rates down very low in times of active trade like the present, they may find that they have exhausted their cheap money ammunition when, in a subsequent trade recession, its stimulating action would have been quite useful.

We would close this survey on a realistic note. Investors should be under no illusion about the powers of the authorities to-day. If a Chancellor of the Exchequer chooses to run the risks of credit creation, if he and his colleagues are prepared to maintain the necessary physical controls, whatever the cost, he has the machinery to sustain or even reduce to-day's interest rates. But on the longer-term prospect—and fixed interest investors should not be obsessed with shorter views—readers must ask themselves this question: Suppose, say, in ten years' time, we have sloughed off most if not all of our controls; suppose we have re-attained something like our pre-war economy—would the nation agree to take on to itself once again to-day's shackles merely because some future Chancellor wanted, in a time of full employment, to reduce interest rates by $\frac{1}{2}$ per cent?

CHAPTER IV

INDUSTRIALS—A WIDE FIELD

Great diversity of industrial share market—Implications of nationalization—Post-war capital needs—Review of leading industries—Steel and nationalization—Engineering—Textiles—Electrical equipment—Consumer goods—Shipping—Results of voluntary dividend limitation—Nominal *v.* real dividends—How companies spend their turnover—Taxation and ploughing back profits—The general yield structure.

THE next few chapters in this book deal with specific sections of the share markets, and will treat of a great variety of shares—from first-class industrial holdings to more speculative descriptions in the mining, oil and plantation markets. First, let us discuss industrials. The industrial sections of the share markets cover an amazingly diversified field of human activity, and really adequate treatment would entail writing not one chapter but several volumes. So broad considerations will form the main theme here. In this brief review there are two points which readers should keep firmly in mind. Any yields on shares mentioned are those prevailing in the spring months of 1949. And where the possibilities of a given share are referred to, this is usually a mere illustration of the argument. Conditions change more rapidly than ever in these days, and the position of any particular share should be checked by reference to current issues of the financial press.

Points affecting nearly all sectors of British industry at the time of writing are the scope of current nationalization schemes; the export drive; the efforts to improve coal supplies and the cost of those efforts; and the effect of the restriction of steel supplies in certain industries. These and the other factors mentioned are cited as typical examples of the influences which investors in industrial shares must constantly be weighing; the nature of these influences will, of course, change with the efflux of time, and the arguments set forth here are merely indicative of the investment forces in operation at the time of writing.

Coal, Cable and Wireless, the main British civil air lines, electricity supply and the railways—all have been nationalized in the last few years. Gas and bus companies are now following,

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and what will happen in regard to steel industry nationalization is anybody's guess until some time in 1950. Any attempt at reviewing the industrial share market, even by a series of generalizations, must take account of the overriding effect of nationalization. What influence will it have on costs? The experience to date of the National Coal Board supplies one answer, and not a cheerful one. Coal itself, electric power and gas all seem likely to cost more. Neither coal costs nor transport costs can be reduced in the short run by a mere change of ownership, whatever may happen in long years to come when the benefits of reorganization and of new capital outlays begin to fructify. Few British industries can be free of anxiety regarding the trend of fuel and transport costs; and so, even though 80 per cent of British industry will theoretically remain outside the sphere of nationalization, in practice that 80 per cent will constantly have to take into account the position of the nationalized 20 per cent. Nationalization will loom larger than ever if anything comes of Labour's further proposals to nationalize cement, sugar refining, and the industrial assurance companies.

An industrial giant such as Imperial Chemical Industries finds its activities so broad-based as almost to represent in itself a cross-section of a great part of British industry. Such first-class industrial equities as I.C.I. are among the least risky shares in the market, but current conditions of taxation and high costs mean that even such an undertaking as this had to raise £20 million of new money by an Ordinary share issue during 1948, after developing its property out of earnings for something like twenty years. The same point must not be lost sight of in considering other industrial market leaders like Dunlop Rubber, Unilever, Distillers, Boots or Courtaulds. The last-named undertaking has huge liquid resources in its development and expansion reserves of £24 million—yet it has been officially stated that it will probably absorb the bulk of these in mere maintenance of physical assets, in view of the fall in the value of money.

The worst of the post-war shortages in coal and in transport facilities seem to be over; but complaints are still rife in this country as regards shortages of manpower in some industries, and of steel in many of them, despite record-breaking steel outputs. In the latter industry, a typical current range of yields is from $4\frac{1}{4}$ per cent for Colvilles to $6\frac{1}{2}$ per cent for Richard Thomas and Baldwins, both shares being marked out for

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nationalization. And the engineering industries, in all their multifarious activities, are closely interwoven with the steel industry itself. So the uncertainty as regards steel industry prospects spreads itself over a considerable section of the engineering industries also. The Bill for steel nationalization announced as this book was in active preparation may never come into force, for much depends on the vagaries of party politics and particularly their impact on the General Election due in 1950. The tentative date set for the Iron and Steel Corporation of Great Britain to take over about one hundred major iron and steel undertakings is 1st May, 1950. They are almost arbitrarily selected from a total of about 2,000 undertakings.

As true nationalization of the iron and steel industries would present problems which seem insoluble in any case, it is not surprising that it has not been found possible in the Steel Bill to draw a logical dividing line between what can be taken over and what must be left to private enterprise. This difficulty arises from the fact that many undertakings, besides producing iron ore, pig iron, ingot steel and hot rolled products, use their iron and steel output as basic raw material for an infinite variety of engineering products. By taking over some companies and leaving others alone, the State performs a vivisection operation on an industry (or rather complex of industries) which is the very pith and marrow of our production effort, and which directly or indirectly is responsible for providing nearly half of U.K. exports. Even where engineering undertakings fall entirely outside the scope of the Bill, they will be condemned to at least eighteen months' uncertainty as to the eventual fate of their raw material supplies. To take one example of the unavoidable capriciousness of the dividing line adopted—Dorman Long would be taken over, Vickers would not. Provisions of the Bill preventing dissipation of assets may paralyse short-term development work.

The Government would become a competitor with private enterprise. Sir Ellis Hunter, President of the British Iron and Steel Federation, pointed out in November, 1948 that the Government would also become an interested party controlling the price and volume of the raw material supplies of its competitors in the finishing branches. And as the owner of the many undertakings to be nationalized by the formation of a State holding company, it would compete in many industries beyond the bounds of iron and steel production—e.g., bridge building, structural engineering, machine tool making.

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Demand for Capital Goods

Whatever may happen to the steel industry itself, there seems likely to be a big demand for steelworks equipment and the like for years to come. The big long-term development plans are sufficient guarantee of that, so companies concerned with supplying steel rolling mill equipment and the like have good prospects for some time ahead. Examples are Davy and United Engineering, and British Rollmakers, but there are others. Capital outlay on steelworks, power stations and the like will also imply a vigorous demand for new furnace linings over and above the normal replacement demand. General Refractories is an important manufacturer of such products.

Shipbuilding shares tend to yield well above the general average for industrials. With yields ranging from $4\frac{3}{4}$ per cent on Cammell Lairds to $6\frac{3}{4}$ per cent on John Browns we have a reflection of the uncertainties regarding steel supplies which, temporarily at any rate, offset recent hopes for settled shipbuilding prosperity until 1952 at least. At the end of 1948 the British shipyards had work on hand and orders worth £325 millions, of which £110 millions were for export. The total gross tonnage concerned was 4,200,000, but in view of the steel situation the annual delivery rate was only about 1,200,000 tons, and this has caused some recent disquiet. Oil tankers played an important part in this total, and it is companies mainly concerned with building tankers (e.g., Swan Hunter) which seem to have the more reliable prospects. The high yields on shipbuilding shares, of course, also arise in considerable measure from past experience of the long-term ups and downs of an industry so subject to the proverbially fluctuating requirements for capital goods. And high costs were beginning to cut orders by mid-1949.

A distinction has to be drawn in industrial undertakings between companies producing capital goods such as heavy electrical equipment, locomotives, steelworks equipment and the like on the one hand, and those concerned with supplying day-to-day consumption requirements such as food and clothing. Early in 1949 the former class still appeared the more attractive, but in due course, if past experience is any guide, the industrial demand for capital goods will decline abruptly for a time.

The great projects on foot for remedying the shortage of refining and transport capacity in the petroleum industry have led of late to rapid expansion in a comparatively new branch of the British engineering industry—that concerned with oilfields

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equipment, refinery and tankage construction and the like. So varied are the requirements of the oil industry that companies in many branches of engineering will play their part in this promising field; and with most of them oilfields equipment will be only one phase of very diversified activities. Two typical cases are provided by Stewarts and Lloyds (steel tubing), now on the steel nationalization list, and by British Ropes. One of the smaller companies which has for many years held a leading place in the construction of oil storage tanks is Whessoe.

In 1948 most types of agricultural machinery made in this country were being produced at ten times the 1938 rate. That increase is one outcome of the Government's plans for a great expansion of British agriculture, but nearly half the 1948-49 output was destined for export. By mid-1948 it could be officially stated that in our machinery exports (an important group) the lead was being taken by agricultural machinery, textile machinery and internal combustion engines. Typical companies with a substantial stake in agricultural machinery are Ransomes, Sims and Jefferies, Ruston and Hornsby, and R. A. Lister. An allied branch of engineering which is coming into increasing prominence is that concerned with mechanical handling—conveyor belts and numerous similar appliances. The agricultural engineers often make these too. Indeed, a trend towards diversification of their activities will be all to the good, as there are signs that the world's manufacturing capacity for agricultural tractors in particular has been expanded rather optimistically since the war ended.

Great disservice has been done to the British aircraft industry by Government indecision in regard to the types of machine to be used by the nationalized British civil aviation industry. The fiasco in connection with the Tudor II air-liner will be fresh in memory; but if any blow to prestige has been suffered by our aircraft industry this hardly seemed to be deserved. Aircraft shares are likely to be high-yielders for a long time ahead, in any case. The companies' long-range development plans should bear fruit in due course, but civil aviation has a series of misfortunes to live down. Even the devotees of nationalization were hard put to it to justify the position of our airways corporations when it was announced late in 1948 that the axe was to be applied vigorously to these organizations. This must obscure the prospect for civil aircraft manufacture for our own airways. On the other hand, the necessity for a measure of rearmament obviously means more military aircraft for the nations joined in the North

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Atlantic Pact, and the aircraft share market was quick to grasp the significance of this. It is noteworthy that for months, while the Pact was preparing, aircraft shares made about the best showing in the industrial market.

Commercial vehicle manufacturers in some respects face a better outlook than that which confronts the makers of private cars (remarkable though the contribution of the latter to the export drive has been). They have fewer difficulties in getting into export markets; and in our exports commercial vehicles are also playing an important part. At home there are far more commercial vehicles in use than before the war, which foreshadows a much bigger replacement demand. Perhaps the biggest query is—if and when the British Transport Commission takes over practically all commercial road transport, will it be inclined to do much of its own vehicle building? Yields on leading shares range from $3\frac{3}{8}$ per cent on Leylands to $5\frac{3}{8}$ per cent on Dennis Motors (where the one-class share capital is exceptionally small in its nominal amount). Several shares in the private car group give high yields reflecting current uncertainties—Austins with $7\frac{3}{8}$ per cent and Morris with $7\frac{1}{8}$ per cent gross furnish examples, though the working alliance between these two major undertakings may have important long-term implications. As 1949 wore on the private car industry in particular was bothered by overseas import restrictions and shortage of sterling for the time being.

Textile machinery is a field in which British manufacturers seem likely to do well for the next few years, though in the long run there may be a falling-off in demand when mills both here and abroad find their re-equipment requirements satisfied. Export demand for such products is strong, and the British manufacturers can quote competitive prices. It does not appear that the principal overseas competitors in this market, the U.S.A. and Japan, are any serious menace as yet.

As regards textile mills at home, though there has been an urgent need for the re-equipment of cotton spinning mills, the Government proposals for easing the resultant financial strain were not found universally attractive. But automatic weaving machinery proved so popular after the war that one big manufacturer of automatic looms had about ten years' orders in hand in 1948—half from home mills.

Cotton, Wool and Rayon

In the export drive the textile industries have been playing an important part, but found it none too easy to attain their export

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targets. Market conditions change rapidly in textiles, so that some of the strongest companies are those up-to-date enterprises whose structure is described in the jargon of to-day as "vertical"—i.e., they are organized to handle every stage in the processing of the raw materials, right down to the merchandising of the finished product, in contrast to the traditional individualism of many old-fashioned textile firms which specialized in, say, spinning alone. Even some of the major companies in the cotton section have had a chequered history over the past twenty years or so, and this is still reflected in some of the yields offered. Examples of the leading equity shares are J. and P. Coats, offering $4\frac{1}{4}$ per cent at the time of writing; English Sewing Cotton, giving $4\frac{1}{4}$ per cent; Crosses and Heaton's with $6\frac{3}{4}$ per cent; and Amalgamated Cotton with 7 per cent gross. Some awkward raw cotton price fluctuations arising from centralized Government buying have plagued manufacturers since the war ended. But some improvement seemed to follow the reorganization early in 1949 of the buying policy of the Raw Cotton Commission. This is all to the good in view of some disquiet regarding Japanese competition. With labour rather scarce it has been necessary to economize in workers by respacing looms in some weaving sheds. A minor example of post-war textile trade worries was the fall in raw silk over two years which lopped off nearly four-fifths of the price. Wool textile companies have found it prudent in recent times to make some provision out of profits for raw materials reserves, these to serve as a cushion against the possibility of a fall in wool prices after the steady increase in these in the first few years after the war. A favourable point for the wool textile industries is the fact that no dollars are needed to buy raw material. High-class English worsted goods are in great demand in the United States and Canada, and some excellent 1948 earnings were reported by companies in the worsted section of the industry.

In the rayon group (which to some extent is concerned with plastics also) the two leading shares are Courtaulds, already discussed in this chapter, and now yielding 4 per cent; and British Celanese, giving $4\frac{1}{8}$ per cent. British Celanese itself, though now highly prosperous, took some time to get on a really stable basis, and several of the smaller rayon and silk undertakings have experienced their hard times. But the industry is doing very well in the export drive, and is favoured in this respect by a relatively modest increase in selling prices.

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The jute section of the textile industry, largely centred in Dundee, is worried from time to time by the prospects of more intense Indian competition, and by doubts regarding raw material supplies. A recent complication has been the splitting of India into two dominions. Pakistan grows about three-quarters of the jute crop of the sub-continent, and wants to build up its own export trade in raw jute. In Dundee it is felt that in the long run the new political structure may result in a more secure jute supply.

The radio group has an erratic record, and since the war ended rebuilding of its home civilian trade has not been helped by repeated changes in the rate of purchase tax applied to its products. Thus those companies concerned entirely or for the most part with radio usually carry more risks than those more broadly based on electrical equipment generally. And companies which manufacture every electrical appliance, great and small, are in a far safer position. The leading shares of this latter type were yielding under 4 per cent in May, 1949. Examples are General Electric, Associated Electrical Industries, and British Insulated Callender's Cable.

Plastics, with their remarkable possibilities, have perhaps been more rewarding so far from the technical angle than from the point of view of shareholders. British Industrial Plastics is probably the strongest organization among "straight" plastics undertakings; but it is probable that the investor is on firmer ground in those companies with substantial plastics interests, but with many other strings to their bows. A leading example is the Distillers Co. At the other extreme of the plastics industry are the rather speculative minor undertakings engaged in the production of small plastic accessories. These are vulnerable.

With stores shares the main guide to prospects is the periodical statistics of fluctuations in retail sales in this country. At the time of writing even the best stores shares offer fairly high yields—such a sound issue as John Barker gives $4\frac{7}{8}$ per cent—as is perhaps not surprising in view of the signs that the post-war spending spree is over. Stores group yields exceeding say $6\frac{1}{2}$ per cent at this juncture should prompt careful examination of the position of the individual company concerned. The chain store undertakings are in a class by themselves. They are likely to be less susceptible to depression than the general run of retail stores, and Woolworths will doubtless continue to prove the strongest of them.

Most shares connected with food processing and retailing give

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fairly low yields—a recognition of the indispensability of most of their products, and of a generally steady earnings record. J. Lyons is pre-eminent in the catering group, but Aerated Bread Co. has been making good progress in recent years. But catering shares, and more especially the allied hotel group, seem likely to be hard hit by the inelastic nature of recently introduced catering wages and hours regulations; these are increasing the operating costs considerably in many cases.

Breweries, generally speaking, had been having a long run of prosperity. In many cases the replacement of war-time E.P.T. by profits tax meant a gain in net profits after deducting tax, and it is common for the best companies to be very conservative in dividing their profits. But the breweries had to contend from the middle of 1948 with a severe reduction in beer drinking which at length resulted from the high duty on beer. And yields on shares, after being low for many years, were adjusted sharply upwards to meet the new conditions ruling as the post-war prosperity peak began to pass away. Shares of companies which have a country-wide (or even world-wide) market for their products, such as Bass or Guinness (the latter's shares yield $4\frac{3}{8}$ per cent), are generally considered the strongest. Most breweries, however, operate in a specific section of the country, and their fortunes are linked with industrial conditions in that section. They must be studied from that angle, bearing in mind the fact that consumption of beer may be affected at times by the size of pay packets.

At the time when Marshall aid was beginning to take definite shape, a severe setback occurred in tobacco shares on realization of the extent to which tobacco supplies were placed in jeopardy by shortage of dollars. Even the strongest companies in this group have felt the effects of adverse sentiment, and of the fear that if anything goes wrong with supplies there may be even more tangible impressions on results. The 1949 outlook for supplies was somewhat more reassuring, but the very high tobacco duty, besides beginning to limit smoking, also means that much more working capital than before has to be locked up in stocks, and companies like Imperial Tobacco thus had to raise large funds to finance raw materials.

The Speculative Film Industry

IN the cinema section the speculative element is uppermost. Events of the past few years in connection with the Rank group

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have shown what great financial risks must be taken in film production, and the decision of the Government to help independent producers with finance illustrates doubts as to our supply of good films. The rapid growth of television has important implications for the film industry. Technical developments may make home television a serious competitor with the films, and theatre-screened television will no doubt become a factor. But, on the other hand, the adaptation of television to film production (as distinct from film screening) is being mooted, and it is believed that as a great time-saver this development might enormously reduce the absurdly inflated cost of producing major films which has long been the bugbear of the industry. By the spring of 1949 one of the periodical crises which plague the film production section of the British industry was well under way. The less speculative end of the industry is that concerned with film exhibition in the great cinema chains. As "disinflation"—the deliberate reduction of public spending power by Governmental action—progresses the marginal spending power of patrons must diminish; and this remark also applies to greyhound racing shares.

During the war and for some time afterwards the earning capacity of British ships was masked by the Government requisitions and by control of freight rates. Now that ships have been released for ordinary commercial voyages earnings are usually good, but shipowners, though often disposing of huge liquid resources received as insurance on ships sunk and the like, express doubts about the long-term outlook; they have some justification in the heavy charge on future earning power implied by the fantastic rise in shipbuilding costs. That is one reason why share prices in this section are often way below theoretical break-up values, which are mathematical exercises based on net liquid assets plus the written-down values of existing fleets. Coal-burning ships are in a minority. Substantial falls occurred in oil-fuel costs early in 1949, and if the low level persists it will materially offset the trend towards more competitive freight conditions.

Paradoxical as it may seem, recent restrictions on newsprint supplies (though a serious matter for papermakers, such as Bowaters) have not been an unalloyed evil for newspaper companies. Competition has been damped down, and though newsprint costs per ton have risen steeply the tonnage consumed has been kept down by the small size papers printed. Newspaper owners will welcome the chance of giving the better service to

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the public implied by the larger newsprint supplies vouchsafed in 1949, but this may not necessarily mean more profit for them; it may mean less. On newspaper and periodical Ordinary shares we can take the current range of yields as varying widely from $4\frac{1}{4}$ per cent to 7 per cent. The goodwill or copyrights item is almost always an important feature of the balance-sheets of this group.

That concludes our rapid survey of some leading industrial sections, and the particular influences affecting them at the time of writing. Overriding these detailed influences, however, is one major factor which affects all industrial shares to-day—dividend limitation. Since this may not prove the temporary arrangement it was at first intended to be, some detailed discussion of the matter seems justified.

Voluntary Dividend Limitation

CO-OPERATING with the Chancellor of the Exchequer, the Federation of British Industries early in 1948 issued a memorandum inviting companies to bind themselves for a year at least to avoiding any increase in the gross amount of dividend on their Ordinary capital. To this general policy of restriction there naturally had to be exceptions. Companies registered and controlled outside this country—e.g., most South African or Australian undertakings—could scarcely be bound by Sir Stafford Cripps or by the F.B.I. And the F.B.I. memorandum itself recognized the existence of hard cases among U.K. registered companies, and enabled them to contract out of the “gentleman’s agreement” with the Chancellor in suitable circumstances. New businesses—a somewhat nebulous classification—may remain outside its scope if thought fit. So may companies which fell on evil times owing to the war, and which are only now resuming Ordinary dividends—examples are Malayan rubber companies, and property companies or certain multiple catering companies which suffered badly from bombing. In several cases these latter groups had only recently succeeded in clearing their accumulated Preference dividend arrears, and it would be manifestly unfair to put such undertakings into a rigid strait-jacket. These exempted companies (provided they are sound in other respects) must supply a substantial proportion of the shares offering capital appreciation prospects while dividend limitation governs the more stable companies. Of course, such a generalization must be treated with caution—for

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example, South African shares are in less favour following the uncertainty created by the Union general election result in the spring of 1948 and by marked deterioration in the economic position; while the London market in our own new companies' shares is plentifully peppered at the time of writing with shares which are quoted to give such high yields that they are clearly looked upon as untried propositions so far as the general public is concerned. Some few of the post-war new issues having presented disastrous initial results, this caution was well founded.

Before dividend limitation became a live issue, many fairly speculative industrial shares were quoted to give low yields owing to the good prospects of increasing future dividends which they enjoyed—they have been humorously named the "pie in the sky" class. Such shares tended to lose their potential attractions as dividend limitation became effective—even though it was conceived on a voluntary basis. Contrariwise, high yielders came into demand for a time, but the market in shares of the companies, often relatively small, falling into this classification suffered some nasty jolts in mid-1948 and onwards in the shape of operating losses and passed dividends, especially in certain sections of the light engineering trades.

So for the time being the tendency under dividend limitation is for interest to turn towards sound market leaders which, if they do not hold out much prospect of dividend increases, should at any rate maintain their existing distributions without much trouble. The great majority of companies accepted the dividend limitation proposals for the first year. A continuation for a second year was accepted rather less enthusiastically, but in any event a change in trading conditions was operating against increases in dividends.

Nominal Dividends and Real Dividends

Now to consider the difference between nominal dividends and real dividends, a matter touched upon when we were discussing Ordinary shares in Chapter I. United Premier Oil and Cake earned 127 per cent under the abnormally favourable conditions of 1947. In emphasizing the abnormal results the chairman also showed that the 20 per cent Ordinary dividend really signified a net remuneration of $1\frac{1}{3}$ per cent only on the true value of the assets represented by Ordinary shareholders' capital. That is a very striking example of what happens where a company constantly augments the real value of its equity capital by

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generous reserve allocations out of net profits. And that is often the reason why industrial Ordinary shares stand at high premiums (United Premier Oils are quoted at over three times their par value).

Is this a usual experience? Figures can be produced to show that it is quite common. At the annual meeting of the Institute of Chartered Accountants in England and Wales held in 1948 the president, Mr. Gilbert D. Shepherd, advocated a policy of educating the public to dispel the illusion, now so prevalent, that enormous profits are being pocketed by shareholders in public companies. And he asked members of the Institute to press for the widespread adoption by companies of two practices when preparing their annual statements to shareholders.

The first of these is the publication of a concise analysis showing the disposition of a company's gross revenue—and thus revealing the relatively small proportion of profit available for shareholders, the heavy impact of taxation, and the retentions of profits necessary to enable the company to carry on as a healthy organism. Mr. Shepherd's second suggestion was the adoption of the practice of stating dividends paid not only as percentages of paid-up capital, but also as percentages of the original capital as enhanced by sums retained in the business over a long period of years.

These are two matters which could hardly be the subject of immediate legal enactment, but advocacy of their further voluntary adoption, especially when emanating from such an influential quarter, is gratifying. Of the thousands of public companies a few are already publishing one or other of the above sets of particulars—in some cases both—while others content themselves with an analysis which shows not how their gross revenue or turnover is carved up, but merely how that slice of it which represents profits is itself allocated as between taxation, dividends, and profits ploughed back.

The real capital embarked in a business can be computed from the published balance-sheet figures in a rough-and-ready way; but the independent investigator cannot possibly gauge the real value of assets which may have been heavily written down in past years, and so it is better to have an official statement of the real capital.

In an analysis covering results published during a month or so two dozen companies were noted as providing the requisite comparison of nominal and real capital and the dividends thereon which is indicated by Mr. Shepherd as desirable. The

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formula employed to denote real capital varies considerably from company to company. "Earnings on capital actually invested in the business" is a phrase that well sums up most of the official descriptions. But it is desirable to make it clear that a comparison of the real Ordinary capital (or equity) with the Ordinary dividend's net sum is the real point at issue.

Some outstanding examples of the misconceptions that may be aroused by a crude statement of the Ordinary dividend percentage may be cited. L. Rose and Company, the well-known manufacturers of lime juice, etc., declared 75 per cent Ordinary dividend for 1947, but the chairman's review stated that this rate should be divided by at least ten in order to show the real rate on capital, which would imply that the real equity dividend rate was under $7\frac{1}{2}$ per cent. Then it was stated on behalf of Davis and Timmins, the screw manufacturers, etc., that there is about 24s. in tangible assets for each 5s. Ordinary share. This suggests that the real Ordinary dividend of Davis and Timmins for 1948 was $8\frac{3}{8}$ per cent, instead of the nominal rate of 40 per cent that was announced.

Taking twenty companies which provided this comparison of nominal and real dividends for their latest financial year, we can arrive at a very rough estimate that average experience is that the real Ordinary dividend rate is only one-fifth of the nominal rate declared—i.e., 50 per cent nominal dividend would on this basis signify 10 per cent dividend on real capital embarked. That seems a surprising result at first sight, though it was broadly confirmed by taking two similar subsequent samples. Still, it might be as well to discount it generously for practical purposes. First, we can reasonably assume that the result is "weighted". Rather on the great Darwin's principle of the survival of the fittest, it must no doubt be the strong companies, provided with really striking comparisons of nominal and real dividends ready to disclose, that do in fact tend to disclose them. But there is good evidence that a really comprehensive cross-section would still show a notable spread. It would certainly be safe to assume that aggregate nominal dividends are at least double the real rate.

The second consideration is that some notable discrepancies between nominal and real capital were entailed by the inclusion in our samples of some post-war new issues. Such companies, owing to post-war obstacles to capitalization of reserves, have not been able to come to the new capital market with a nominal capital properly reflecting the actual sums sunk in the business. Here are two of our new issue samples which emphasize this

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point—Bentalls' nominal dividend was 80 per cent, but the real dividend was calculated as barely 5 per cent; David Whitehead's nominal 75 per cent contrasted with a "real" calculation of $4\frac{3}{4}$ per cent net in 1947, and $4\frac{1}{8}$ per cent in 1948.

The "all-in" analysis of turnover is the most convincing form of evidence as to the relatively small slice of a company's gross revenues that is finally available as net profits. Where this is presented in the form of a diagram or chart, it is comparatively easy to understand; and some companies issue such diagrams to their workers as well as their shareholders, while others advertise their charts in the financial press. One of the best examples of such expositions to hand in 1948 was that of De Havilland Aircraft, and another was provided by the annual report of Monsanto Chemicals; it is not surprising, in view of the alliance with the prominent American company of similar title, that the Monsanto Chemicals report follows a commendable U.S.A. practice in being plentifully illustrated with many diagrams bearing on the matters discussed above, as well as many others.

Monsanto's or De Havilland's publicity policy probably represents the zenith of what can be attained in present circumstances by voluntary action in this country. We could think of a number of companies whose annual reports have plumbed the depths of obscurity for years past; the most glaring examples of this policy will be eliminated by the requirements of the new Companies Act in the great majority of cases.

Where Company Income Goes

WHEN the Electrical Trades Union held its annual conference at Great Yarmouth in the spring of 1948, the bracing atmosphere was perhaps partly responsible for the inflated terms of a resolution (carried with one dissident) which called among other things for a substantial reduction in the "exceedingly high" rates of profit, and for precedence of wages and living standards over profits and unearned increment. The last clause of the resolution rather suggests that the executive council (which sponsored the resolution) was banging at an open door. Some union leaders, at any rate (e.g., Mr. Deakin) realized the true position, but this resolution is typical of an attitude of mind prevalent even among leaders who should be better informed. And if the figures we use in this review are at all typical—as we believe them to be—the first clause of the electricians' proclamation seems ridiculously inaccurate. But who are we to

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smile at them? Even large investors, to say nothing of small investors, are sometimes vague as to the true interpretation of dividend declarations and profit statements.

They may well be puzzled at times by the casualness of the companies themselves. Luckily, ill-informed criticism of profit-making (which profit-making in most cases is a virtue anyway, and not the vice it is often claimed to be) is now spurring many companies to publish the facts at last. Here are some of them:—

TYPICAL 1947 DISPOSAL OF EACH £1 OF TURNOVER					
<i>Running Costs</i>			<i>Taxes and Profits</i>		
1. Materials, etc. ...	10s. 6d.		6. Taxes ...	1s. 2d.	
2. Wages, etc. ...	6s. 0d.		7. Shareholders' dividends	5d.	
3. Materials and Wages*	16s. 6d.		8. Added to surplus ...	5½d.	
4. Depreciation ...	9d.		9. Distributable profit†	10½d.	
5. Overheads, etc. ...	8½d.		10. Profit before tax‡	2s. 0½d.	
* Total of items 1 and 2. †Total of 7 and 8. ‡Total of 6, 7 and 8.					

In 1947 the typical British industrial manufacturing company spent about half its total income on purchasing materials, power, etc., and another three-tenths on wages, salaries, pensions and the like. Figures so far to hand for 1948 approximately confirm these proportions. So materials and wages commonly absorb about four-fifths of total income. But out of the remaining one-fifth (4s. out of an original £1) depreciation must be provided to take care of the wear and tear of the properties with the aid of which income is earned at all; and there are also a great variety of unavoidable overhead charges.

In the end, therefore, it is usual for the profit to be only one-tenth of the total turnover; and, as Sir Stafford Cripps very fairly pointed out to trade union representatives, the Government taxes this profit heavily. As a rule it takes considerably more than one-half of the profit (as struck subject only to taxes). And this means that of the 2s. 0½d. in the £ profit before tax, shown in our typical example, the Government takes 1s. 2d. as taxes.

In the end our typical company is left with a trifle over 10d. as net profit out of the 240 pence with which we started this analysis. And the directors can then decide how much of this they can then pay out to shareholders (subject to voluntary dividend limitation nowadays) and how much they ought to retain for financing improvements. As the above table shows, it is usual to pay out one-half of the tenpence as dividends and to retain the other half for such purposes as keeping equipment up to date. By this and allied efficiency measures British manufacturers may in time offset the effects of two world wars on their business. The

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closer impact of these wars on the British economy is certainly one point to bear in mind when comparing the turnover analyses now being published here with those current in the U.S.A. There, it would seem, profits (before taxation) in some cases bear an even smaller relation to sales, and it is naturally argued that American efficiency methods are one factor in this contrast. So the inauguration during 1948 of an Anglo-American Council on Productivity was a very interesting development.

On such questions it is worth recalling that for years it has been a common complaint of directors that out of taxed profits they had to set aside additional depreciation allowances, because the amounts recognized by the Inland Revenue as an expense deducted before computing taxable profits were quite insufficient. Some, but not much, relief has been granted in recent years, and such relief must have been largely neutralized by additional replacement costs. By the end of 1948 the "depreciation gap" had become the subject of active controversy among accountants, many of whom will not admit that present day net profits are overstated in the sense that a deduction for additional depreciation provision is necessary in many cases.

Many companies have recently published turnover analyses along with the annual report or in the chairman's review, and others have given less elaborate guidance as to the position. Our second table is based on careful inspection of many such analyses, from which we rigorously excluded any that might distort the general picture—e.g., it is better to consider retail stores separately, and to confine the calculations to companies engaged primarily in manufacturing industries.

Various other problems arise in the rather laborious task of reducing these official analyses to a common basis. Some of them give the details based on each £1 of sales or turnover; some go in for percentage figures; a few provide diagrams only, which can, however, be translated into £ s. d. with a little ingenuity; and some give the total sums involved in each item of outlay. Then the grouping of the items is apt to vary. It is necessary to mention these difficulties, for they emphasize a point on which we are anxious to lay stress—namely, that too much should not be read into our "typical" 1947 disposal figures by shareholders, and that still more caution must be exercised in reading the individual figures set out in our second table. This provides details for a number of leading companies which happen to have published analyses upon a fairly uniform plan.

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HOW SOME LEADING COMPANIES SPENT EACH £1

1947 Results‡	Materials etc.	Wages etc.	Materials plus Wages	Taxes	Distributable profit*		
					Total	Divs.	Re- tained
	s. d.	s. d.	s. d.	s. d.	s. d.	s. d.	s. d.
Assoc. Elec. Industries	7 1	7 4	14 5	1 2	10	4	6
Assoc. Port- land Cement	12 6½	3 10½	16 5	1 10	8½	7½†	1
Ford Motor General	13 1	3 7	16 8	1 1½	1 0½	3½	9½
Refractories	9 0	5 3½	14 3½	10½	8½	2½	5½
Imperial Chemical	11 7½	5 3	16 10½	1 3½	1 2	6½	7½
Lancashire Dynamo	9 7½	6 4½	16 0	10½	9½	5½	4
Monsanto Chemicals	12 11	3 2	16 1	1 10	1 8	1 2	6
Pool Lorrimer & Tabberer	12 1½	3 3½	15 5	1 5½	11½	6½	5
Rugby Port- land Cement	12 7	3 9	16 4	1 3	1 3	9†	6
John Summers Vulcan	10 9½	5 6½	16 4	1 6½	10	5½	4½
Foundry	10 0½	8 0½	18 1½	8½	1 1½	7	6½

*Distributable profit is struck after deducting taxation, and also after other (generally small) deductions not detailed here—e.g., depreciation and overheads. Some examples of depreciation charge per £1 turnover follow:—Associated Electrical, 5d.; Associated Portland Cement, 1s. 0½d.; Imperial Chemical, 7½d.; Monsanto Chemicals, 5d.; Pool Lorrimer, 5½d.; Rugby Portland Cement, 1s. 2d.; John Summers, 6½d. †Includes preference dividends, etc. ‡In most cases 1948 analyses are also available as this book goes to press; their general pattern is similar to 1947 figures.

We do not advocate any attempt to compare the merits of one company with another merely on the basis of these turnover analyses, for so many other factors must be borne in mind; for instance, the proportion of turnover taken by wages varies a good deal according to the nature of the industry.

Some companies are affected much more than others by the cost of materials. A striking instance was provided by figures quoted by the Earl of Verulam, chairman of Enfield Rolling Mills, whose raw materials are metals. In this case purchase of metals absorbed no less than 16s. out of each £1 of 1947 turnover—perhaps an extreme case, but one which certainly emphasizes how serious a position arose from Government tardiness as to reopening the London Metal Exchange. And dividends in this case took only ¾d. out of every £1 of turnover,

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so they could not possibly have any material bearing on production costs.

Having examined a large number of companies, we see that of every £10 of turnover the average experience was that over £8 went in wages and materials and that after allowing for depreciation, overheads, etc., the profit left was little more than £1. "Profit" is here taken to mean profit subject only to taxation—out of the £1 must come taxes; remuneration of any Preference capital; Ordinary dividends; and money retained in the business, or "ploughed back". As to profits ploughed back, a great deal more detail is available than is the case with the "all-in" turnover analyses already discussed. For the turnover analyses we depend on what special information the companies may choose to disclose. Enlightened undertakings are beginning to provide these details.

But at least a partial analysis revealing the amount of profits ploughed back for improvements, etc., can be made from almost any published profit and loss account, though it is true that a commentator cannot hope to get so near to the truth as in those cases where companies themselves publish details on this point. For some of the ploughing back may have been done before profits are struck in the published accounts; in some cases it can be effected by making depreciation allowances on a particularly generous scale, where profits are sufficient to permit this course—even though this means paying heavy taxation on that part of the depreciation charge not allowed by the Inland Revenue as a working expense in computing profit.

To provide a reasonable sample we examined the results for about 130 industrial companies, many of which provided official details of the proportion of profits ploughed back—though for others we relied on our own unofficial analysis.

Tax Burden on Retained Profits

As might be expected, the average experience is that of the £1 of profit left out of £10 of total income, as much as 11s. goes in taxation. We can take it that United Kingdom income tax at 9s. in the £ on the year's taxable profits represents the major part of this tax charge. Where does the other 2s. in the £ come in? Well, some companies provide something towards future tax liabilities; but first and foremost there is the distributed profits tax, which at the time of passing this chapter for press is charged at 25 per cent (5s. in the £) on all profits *before* they have borne

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income tax—but with a rebate of 15 per cent (3s. in the £) to ease the burden in respect of that part of the year's profits which a company decides not to pay out to its shareholders.

Believe it or not, this tax assumed its present form at Mr. Dalton's instigation as a means of encouraging companies to adopt the habit of saving! Plenty of hard words have been printed about the profits tax, so that here we may be content with noting that profits paid out as dividends now normally bear taxes at a total of 11s. 4½d. in the £ by a combination of profits tax and income tax; and even profits retained in the business still bear as much as 10s. 1.2d. in the £ arising from these two taxes. Since profits tax cannot be passed on to shareholders by deduction from their dividends (as is done with income tax), the ploughed-in profits in effect have to bear all the profits tax. Suppose a company distributes £50 gross dividend from every £100 earned (before profits tax), shareholders get £27 10s. net from this, after the company has deducted £22 10s. for income tax at 9s. But the £50 retained is reduced to only £17 17s. 6d. by £17 10s. profits tax and £14 12s. 6d. balance of income tax still due after allowing for the tax taken off dividends. And post-war replacement costs are alarmingly high. Note also that in effect Ordinary shareholders feel the burden of distributed profits tax applicable to dividends on Preference capital where that exists, as well as their own portion of this tax.

Payment of 11s. in the £ for taxes left 9s. for dividends or ploughing back, according to the dictates of policy—and not forgetting voluntary restriction of dividends. In fact, the average experience of the 130 companies was that substantially more net profit (after taxes) was ploughed back into businesses than was paid out in dividends—we make it 5s. retained per £, and 4s. distributed per £. The relative insignificance of this latter sum when translated into terms of gross sales will be fresh in memory—we have already shown that shareholders' net dividends in the average case represent only 5d. in every £1 of turnover. Some calculations based on the new comprehensive figures covering all company profits which appeared in the 1948 National Income White Paper provide a result broadly confirming the above taxation, retention and distribution estimates.

The usual warning that too much must not be read into such average figures must be reiterated. The proportion absorbed by taxation may seem abnormally low or abnormally high in the case of certain individual companies, and many factors could account for this—writing back earlier tax provision not required

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after all, or some special transaction representing the backwash of war-time E.P.T., might be instanced as examples.

But such inhibitions can be thrown off when considering the other point which arises—the profit distribution policy. Some striking examples of conservatism can be quoted. Cunard, Ford Motor, Vauxhall Motors, General Refractories and Johnson and Phillips all provided instances where the proportion of the 1948 profits retained (subject to income tax) very substantially exceeded the gross dividend distribution. To test further the current trend of directorial policy in this connection, recourse may be had to the new calculations of *The Economist*, based on the more comprehensive company accounts prescribed as from July, 1948 onwards. In the first quarter of 1949 these calculations covered 467 companies. On nominal capital they showed average gross Ordinary dividends of $17\frac{3}{8}$ per cent and average gross earnings of $31\frac{5}{8}$ per cent. There are many individual companies which are more conservative than the average undertaking, and investors will do well to look out for them.

Three points have to be borne in mind in connection with these percentages. First, both the $17\frac{3}{8}$ per cent and the $31\frac{5}{8}$ per cent are computed gross—before deducting income tax at 9s. in the £. Second, since the earnings and dividends are all on the equity or “risk” capital they reflect not at all the relatively modest interest rates paid on Preference capital ranking before the equity—Preference capital which is often very substantial in amount. Third, the average company’s “real” equity capital, owing to ploughing back profits, is at least twice the nominal amount on which Ordinary dividends are declared. There are a very large number of cases where the “real” capital is as much as five times as great, or even more, and where proper adjustment makes earnings look correspondingly modest. Where Ordinary capital is highly geared, on the principle explained near the end of Chapter I, dividends and earnings spread over the entire capitalization would often give much more moderate overall percentages in individual cases.

Diverse Yields on Industrial Shares

WHY is there such a great diversity in the yields on money invested in industrial Ordinary shares—such yields ranging from 2 per cent or so to, in some cases, over 10 per cent? What are the influences on the trend of representative yields in the industrial field generally, and what are the factors peculiar to a certain

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company, or to the companies in a given industry? Can we trace any correspondence between the ups and downs of the average yield on the best industrial shares and the fluctuations in the yield on British Government securities? Some of these questions we shall try to answer in concluding this chapter.

First, let us see what the range of yields on industrial Ordinary shares is like. On that select group of the soundest industrial equities used for the *Financial Times* daily yield index the average return was nearly $4\frac{3}{4}$ per cent on 13th May, 1949. The Actuaries Investment Index casts its net more widely, and is based on 120 industrial shares; it stood at a share over 5 per cent at the end of April, 1949. At the end of May, 1947, the average shown by this index, which is compiled monthly, was $4\frac{1}{4}$ per cent.

The quite considerable net rise in the index meanwhile was linked closely to the higher yields ruling for British Government securities. The whole "scale of credit", as the range of yields on various classes of securities is sometimes conveniently named, is in the long run governed by the interest rates at which the Government can borrow, and so the movements in industrial share yields during 1948 were largely conditioned by the failure in 1947 of Mr. Dalton's attempt to drive down the interest yield on long-dated British Government securities to a $2\frac{1}{2}$ per cent level.

When industrial Ordinary shares slumped at the beginning of September, 1947, in accord with the gilt-edged setback, the yields on this class of shares naturally rose correspondingly—the lower the price of the share, the higher must be the yield on it, given an unchanged dividend. So, early in that September, the *Financial Times* daily yield index showed 30 first-class industrials yielding an average of just about 5 per cent. By the end of 1947 industrials had recovered a good part of the autumn losses, and the yield index was back to about $4\frac{1}{8}$ per cent. Later on Sir Stafford Cripps' special investment levy gave the gilt-edged market another temporary attack of the jitters, and, as before, industrials followed suit. But on the second occasion the consequent rise in yields was not so pronounced, and the peak touched by the *Financial Times* yield index was just over $4\frac{3}{4}$ per cent. From July, 1948, there had been appreciable recovery in quotations for both gilt-edged stocks and industrials, but in the first quarter of 1949 the latter group lost ground again.

These examples taken from recent movements will show that there is some correlation between the yields on gilt-edged stocks and those on industrials. But here we come to an important

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point. A graph showing the trend of these two classes of yields will indeed show the two curves moving in general agreement over long periods; but the spread between them varies quite a lot. And this "differential" between gilt-edged yields and those on even the best industrial shares needs watching very carefully. In mid-May, 1949, for example, we find the yield on $2\frac{1}{2}$ per cent Consols at $3\frac{1}{8}$ per cent and the average yield on thirty "blue chip" industrials at $4\frac{3}{4}$ per cent. The differential, $1\frac{5}{8}$ per cent at that time, early in 1948 had been little more than 1 per cent, and the two curves were still closer together than they were in the previous September of 1947, when at one time there was a spread of 2 per cent at least between Consols and industrials.

In respect of each day of Stock Exchange business the *Financial Times* prints these daily yield indices in a little panel on its front page, and anyone who has occasion to keep an eye on industrial share yields might do worse than plot these curves regularly on a chart. When the two lines get too close to each other—"too close" being defined by previous relationships—the amber light may be shining.

A few thoroughly good industrial shares yield around 4 per cent at the moment. But no matter how good they are, they should be closely examined to see how far such a low yield can be justified with the ceiling on dividends prevailing for the time being.

So much for low yielders. Equal caution, though, perhaps, for different reasons, has to be exercised in connection with exceptionally high yielders. The indices, as is shown by their trend, are based mainly on the very high-grade shares. But there are many issues which yield appreciably more than 4 per cent, and among which careful selection will reveal reasonably sound holdings of their kind, with a very large surplus of earnings over the dividend rate being paid. In some cases, of course, high post-war plant replacement costs will fall to be met largely out of such surplus earnings.

DISTRIBUTION OF GROSS YIELDS PER CENT ON 765 INDUSTRIALS

Categories	No. of yields	Ratio to total
A.— $2\frac{1}{8}\%$ to 4%	69	9%
B.— $4\frac{1}{8}\%$ to 6%	398	$51\frac{3}{4}\%$
C.— $6\frac{1}{8}\%$ to 8%	183	$23\frac{7}{8}\%$
D.— $8\frac{1}{8}\%$ to 10%	87	$11\frac{3}{4}\%$
E.—Over 10%	28	$3\frac{3}{4}\%$
Total	765	100

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The 765 sample industrial Ordinary share yields tabulated were extracted over a period of nearly a year to April, 1949. Well over half of the individual yields fall between 4 per cent and 6 per cent, and more than one-fifth between 6 per cent and 8 per cent. Category "A" (2 per cent to 4 per cent) embraces less than one-tenth of the total, and though yields under 4 per cent, generally speaking, signalize a high-grade industrial share, the quality of the holding will have to be very good indeed to justify such a rating. Voluntary dividend limitation is tending to weaken the case for pricing a share at a level which unduly discounts the prospect of dividend increases later on.

Shares which yield over 10 per cent are met with very infrequently in our sample of industrial issues. There is a special case for high-yielding shares discussed in Chapter XVII; but the small investor will be wise to examine the position of such issues critically and carefully when they yield, say, 6 per cent or more. And when a share is yielding over 10 per cent there is often an adequate explanation in the position of the particular company concerned. Some of to-day's high yields provide danger signals in regard to the less successful of the enterprises introduced to the public through the post-war new issue market. Others often mean that the outlook for given industries is considered very uncertain. And the current trend towards avoiding dividend increases, even in those cases (now becoming rarer) in which earnings show a strong upward tendency, must itself often operate to push quotations down and yields up.

CHAPTER V

HOW TO SELECT MINING SHARES

Factors affecting gold shares—South Africans—Diamond shares—Base metal shares—Mines are wasting assets—Estimating a mine's life—Developing propositions—The "shops"—Influence of costs—Technique of mining—Geophysical surveys—What boreholes disclose—Diamond drilling—Reef widths and inch-dwts.—Shaft sinking—Ore reserves—Alluvial mining—Dredges.

FOR the investor the mining share market can be full of pitfalls, for the normal hazards of investment are present, and more besides. But with common sense, coupled with close study of day-to-day developments reported and commented on in the financial press, there is no reason why the mining investor or speculator should stand at much disadvantage.

First, let us make a rapid survey of the multifarious wares which the mining share market places at the disposal of a potential purchaser. So far as metal mining is concerned, we have a clean-cut distinction between gold shares on the one hand and base metal shares on the other. The fundamental difference lies in the pricing of the respective products in world markets. For many years the gold price has been fixed in terms of American dollars, the U.S. Treasury purchases at \$35 an ounce providing a standard which the World Bank and the International Monetary Fund do their best under their articles of agreement to keep inviolate, or at any rate subject to a very small differential margin. Those august authorities are apt to be testy when any one of the gold producing countries gets out of step on this question, as deals in gold at higher prices tend to undermine carefully laid world currency plans that are especially important in these difficult post-war years.

Nevertheless, the Belgian Congo producers and producers in the French Empire were among those which, with the approval of their metropolitan authorities (if not with that of the International Monetary Fund), have been given a chance on occasion to sell some of their gold at free market prices, which, of course, means higher prices than the sacred \$35. Even South Africa flirted, in the midst of its economic difficulties early in 1949, with a project for obtaining a better price for a little of its gold.

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production—an incident which by no means pleased the I.M.F. authorities.

The chances of any material rise in the U.S.A. gold price seem slim, despite the strong pressure occasionally exerted towards this end, on the ground that a given quantity of gold will now (1949) buy only about half the volume of commodities commanded before the war. (Incidentally, when commodity prices start to fall, gold shares may be expected to go up, generally speaking. A fall in commodities also spells lower working costs for gold mines.) Financial editors are often bombarded with ardent letters from gold mining shareholders propounding ingenious schemes for substantially raising the gold price. But such proposals seem to stand little chance of adoption. Their popularity with shareholders underlines the fundamental difficulty which faces all gold producers—the price they receive for their gold is fixed, but their production costs are continually rising under post-war conditions. This limits profits per ton of one treated—and, perhaps more serious still, it tends to take large amounts of less valuable ore reserves out of the payable category altogether.

This fixed price factor can be taken as for practical purposes applicable to all gold producers. On the other hand, base metal producers generally saw a remarkable rise after the 1939-45 war in the prices they could secure for their products. To some extent this proved temporary.

Producers *vs.* Developers

PROSPECTS for individual gold mining companies are very different when the company is an established producer, with the limit on its revenues implied by the fixed gold price, from those which rule when an undertaking is still being developed into a producing gold mine. In the latter case the speculative glamour of the discoveries likely to attend the opening up of the mine will from time to time galvanize the shares into considerable activity. So it is that mines which have still to reach the producing stage often provide the most attractive speculations—subject to the snags which we shall detail later on. But for those who desire to spread their risks in the gold share market it is possible to achieve a judicious admixture of speculation and investment, and a balance between developing mines on the one hand and producers on the other, by investing in the shares of mining finance houses—virtually active investment trusts specializing in

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mining shares. Among such, the wise investor will select a sound South African finance house for preference.

The influences which tend to move all South African gold shares as a class are mainly the recurrent rumours that the price of gold will be increased, the up-and-down movements in world commodity prices generally, and the perennial hopes each spring that South African mining taxation (so important to the Union's Budget) will be altered to the advantage of the companies. The individual influences are, of course, legion—development news from each separate property and so forth. In the nineteen-fifties we may expect to find extensive developments in the Orange Free State goldfields, which are obviously becoming a major factor, though only emerging from the "borehole" stage as these lines are written in the spring of 1949.

In the West African goldfields there is at least one remarkable mine, the Ashanti Goldfields, which for many years had a notable dividend record, but as a whole this market is a difficult one for the man in the street. Hopes of less onerous local taxation of the industry are the main stimulating factor which operates now and again; but the palmy days of the "Jungle", as this market is nicknamed, seem to have departed.

Australian gold shares have some past history to live down, and in the Western Australian fields the post-war rise in operating costs has been described as alarming. Spasmodic attempts at subsidizing the industry can hardly bring permanent benefit. Indian gold shares enjoy a little favour from time to time, but in recent years have groaned under a specially heavy burden of taxation in India, from which some slight relief is expected.

Monopoly in Diamonds

DIAMOND shares benefit from the virtual monopoly of the diamond market enjoyed by the single selling agency with which all the big producers are closely linked. The shares often give high yields in the circumstances. In the unsettled currency conditions succeeding the war gem stones have been in strong demand as a means of safeguarding capital. Many such stones might come on the market if currency troubles eased, but that does not seem very likely. A great growth in the demand for industrial diamonds was a feature of 1948. To the extent that this represents stock-piling by the U.S.A. such demand may not be fully maintained.

Prices of base metals generally have shown some dramatic increases in the past few years. The demand from the U.S.A.

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for building up stocks of strategic materials has been one important factor, and the abounding prosperity of the States in the first few years after the war ended also produced a commercial demand from that quarter which can be taken as the major influence for the time being upon most base metal prices. Continuation of this state of affairs is clearly linked with current trends across the Atlantic. When commodity indices fall back in the U.S.A., holders of base metal shares must be vigilant, though producers can safeguard their position by making forward sales of metals at good prices when practicable. The post-war peak for these products now seems to have been passed, but the long-term outlook for base metal prices generally is perhaps not unsatisfactory. Deposits exploitable at low cost are scarcer than they were.

Rhodesian Coppers—Malayan Tins

THE exceptional nature of the ore bodies in the Northern Rhodesia copper mines means that any fears for the life of these undertakings are as yet far ahead. Demand for copper is buoyant with the growth of world-wide electrification schemes. American interest in these Rhodesian shares enlivens the market from time to time. The chief bear factors are the chance that copper prices will ease with other base metals, and the prospect that the local legislature may look further into the possibilities of the industry as a source of revenue.

The tin share market is largely swayed by considerations arising from American stockpiling of this and other metals. How long this operation may dominate the market is uncertain, but Malayan tin producers in particular are anxious for definite light on their long-term position. If the Americans decided to sell off their stockpiles later on, producers might well be harmed in the absence of proper safeguards. Malaya's concern is, of course, accentuated by the fact that the tin industry there has had a heavy task of rehabilitation since the Japanese surrender in 1945. A world tin regulation scheme has been mooted. High cost producers, such as Bolivia and Nigeria, would like to stabilize peak tin prices for a number of years. Tinplate industries, the most important outlet by far, learned how to economize in the use of tin during the war.

The fortunes of lead and zinc producers are largely bound up with demand in the U.S.A., where there was a veritable scramble for lead supplies in particular during 1948, but many signs in the

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following year that buyers were beginning to hold off. Car battery manufacturers are very important consumers of lead, so the motor industry's fortunes have to be watched.

Any mine, whether it be gold, silver, lead, tin, copper, diamonds, or anything else, has a limit to its life. This is the period in which it is estimated that all the payable ore will have been extracted; and of necessity it is approximate. Nevertheless, it behoves the prospective buyer of shares to make due allowance for the fact that one day the property in which he is interested will be worked out. Then, beyond the proceeds of sale of the surface freehold and sundry machinery, etc., very little capital return can be expected. However rich and profitable, any mining proposition with no more than a few years' remaining productive life must be regarded with scepticism.

The life of a mine may be curtailed by reason of the fact that rising costs or lower metal prices have rendered big tonnages of ore unpayable. And thus the time may come when a property must cease operations, although substantial tonnages of such unpayable ore may still exist. Or again, it may be simply a question of complete exhaustion of ore. To the length of life the ore reserves will provide an important clue, as will the nature of underground development *taken over a period*—it is obviously the trend of development rather than any occasional good or bad patches which must be the overriding consideration.

Moreover, a persistently diminishing profit ratio will sooner or later affect the ore reserve position and thus the length of life. The amount of development footage done from month to month is of importance, particularly the "percentage of payability" arising therefrom. However much reef is exposed, it will not be of importance unless sampling has proved a useful percentage to be payable.

If we could precisely predict the remaining life of a given property it would, of course, be actuarially possible to decide what proportion of dividends should be set aside for ultimate redemption of capital—and should the "real" dividend income remaining after this provision fail to provide a satisfactory yield on the market price of the shares an overvaluation would be indicated.

When Mines are on the Wane

BUT obviously it is not until comparatively late in a mines' career that this factor is regarded at all. Once it has become

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generally appreciated that productive operations are past their zenith, the downward adjustment in the price of the shares is often correspondingly sharp. A comparison of 1949 prices of some of the older Rand mines with those of ten or fifteen years ago would emphasize this point. Investors in all gold producing mines should always keep in touch with the technical position of the property in which they are interested, and should pounce on even the smallest indication that productive life may be on the wane. In such circumstances there is much to be said for the policy of switching into younger companies—those with the greater part of their productive career before them. That is the right attitude for the investor concerned mainly with income, and such procedure is essential if big capital losses are to be avoided.

So far as the Witwatersrand gold mining companies in South Africa are concerned, fairly close estimates can be attempted of the remaining lives, owing to the unique regularity of the gold-bearing “banket” reefs in this field. It is known to what extent reefs within a particular claim area have been worked out, and by reference to the remaining claim area rough calculations are possible.

But to do this we must be sure that the property is underlain by the orebody with considerable regularity, and thus there must be greater uncertainty over this question in the case of the quartz gold mines which comprise the majority of the producers outside the Rand. The Tarkwa banket range on the Gold Coast is a notable exception. Yet it would be wrong to assert that these properties must have doubtful life prospects, though it is not possible, generally speaking, to say with any assurance that this or that mine will have a life of a given number of years. Many such mines have already been regular producers for several decades, and may continue in operation for several more. On the other hand, the history of mining can provide many examples of the sudden demise of a property almost within two or three years.

These remarks so far have been concerned with lode gold mining, which occupies by far the most prominent place in the London mining share market. However, the remarks on this “life” question apply equally to other metal mining propositions. For the present, “life” worries are little heard of where companies are concerned with extraction of lead, zinc and copper. Lead and zinc, normally mined together, are worked in the main by companies which have a fair assurance for a considerable time

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ahead of being able to continue profitable operations. But there are cases where doubt exists. The Rhodesian copper mines—still, as mining goes, comparatively young undertakings—have few fears over this question, since enormous tonnages of copper ore have been shown to exist by detailed drilling.

Interest in dredging undertakings is mainly confined to the Malayan tin producers (not all of which, however, are dredging companies); while a few gold dredging propositions are also to be found. Before a company embarks on a dredging career preliminary work in the form of boring and check boring will have provided a reasonably accurate picture of the cubic yardage available for dredging, and since the number of dredges and their yearly capacity will be known, a fair approximation to the life may often be possible.

Amortization of Mining Holdings

MANY mining investors pay no regard at all to this question of life, contemplating their holdings much as if they were in normal industrial or financial undertakings. In this way much capital has often been lost. If the property is thought to have a short life, a proportionately large part of the dividend received should be set aside as a return of capital; this is termed amortization. For the same reasons, high yields on mining shares should be regarded by investors with some caution. Generally speaking, they are high because the life is short. Investors should not live on the proceeds of such investments without appreciating that if they do so they are in fact living on capital. Tax free depletion allowances made by revenue authorities of various countries recognize this fact, though the U.K. Government admitted it only tardily in a clause in the 1949-50 Budget proposals—by supplementing a 1945 allowance.

There are many companies which are still only exploring for payable ore. Clearly the life question does not yet affect them. Such a company may be confining itself merely to the sinking of boreholes, or its operations may not yet have passed beyond the stage of geophysical surveying. It may be carrying out only trenching and other surface work, or, though prosecuting actual underground development as the last stage before production, it may still have to establish a worthwhile ore reserve or erect a treatment plant. The shares of all such companies clearly can be given no investment ranking (unless more established interests elsewhere are also held), and must be speculative in greater or

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less degree. But the mining market being what it is, speculative capital will always play a big part in its fortunes. How should the mining investor (if we can call him an investor in this context) approach this type of mining share?

This is no easy question to answer, for so often he has little information to work on. A share may have risen, say, 25 per cent, but in the mining market that would not necessarily prevent a rise of another 50 per cent. Nor does yield count greatly, for as the cynic says, a mining share is "finished" when it starts to pay dividends. An established producer may indeed be the subject of "speculative activity", but more normally it is not so. Anyone putting money into a mining proposition which has still to attain the production stage should realize the greater risk attaching to his "investment". Many non-producers—gold or otherwise—can almost be classed as "certainties" by reason of the development work they have accomplished, or by reason of prospects justly inferred from the experiences of neighbouring properties and contiguous ore bodies. But in many instances no such view may be taken—though the shares of the company concerned might nevertheless be among the most active. If the speculator (as we must now call him) recognizes the sort of share in which he has placed his money, he should at any rate be prepared for subsequent shocks.

He can minimize these. He can inquire about the ability—indeed, the integrity—of the management of the company concerned, for whereas ideal management cannot make a good mine out of a bad one, a good mine might never see the light of day—or at any rate might be botched completely—if not in capable hands. It would be no bad thing to adopt a generally sceptical attitude. Isolated news from the mine, be it never so good, should rarely be treated on its own merits alone, but should be taken in conjunction with relevant data already to hand. Again, when considering regular development results he should not be swayed, as so often is the market, by an isolated run of good developments, but should be equally aware of the poor patches encountered during the same period. He should also be wary of any colourful mining reports that may appear—reports which go beyond the purely factual and make great play of such adjectives as "encouraging", "promising", and so on. If development is encouraging and the mine's prospects promising, the facts will speak for themselves.

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Importance of the "Shop"

Not all, but certainly a great number, of mining companies come under the centralized technical and financial control of a mining investment company familiarly known as "the shop", which itself is at liberty to deal in the shares of its satellites. We often read of "shop support"—which merely means buying on behalf of the controlling finance company. To suggest that these companies only buy shares, and do not sell them, would be absurd. It is always superficially reassuring to learn that the "shop" is a buyer, particularly since such information might well connote the existence of good news of which the publication might for one reason or another not be politic until later on. The shares in question may already have had a steep rise, and when the "shop" starts to sell no one will be the wiser. The speculative operator will have to make the best he can of such meagre news as is available. He must endeavour to appraise the market position, must note the existence or otherwise of "shop" interest—and must recognize, above all, that he is taking a chance whether he is a bull or a bear.

Such remarks normally apply to the shares of those companies still undertaking comparatively early work on their property—the properties whence we get the "borehole booms" for which the mining market is so noted. It would be doing less than justice to the many developing mines quickly approaching initial production if reference to their position were not made. In the nature of things there are numbers of such companies which have started to attract the attention of the more permanent type of speculative investor. Here the position of the property will be of first-rate importance. If, for example, its mineral rights are covered by an area wedged between that of two existing producing mines its prospects, other things being equal, would be better than those of a company operating in virgin territory.

Comparatively close boring over a considerable distance may have firmly indicated the existence underground of a sizeable stretch of payable ore. Or actual shaft-sinking and development may have proceeded far enough, coupled with official production plans, for tentative estimates to be made of earnings, if not of what the life is likely to be. Expenditure, projected and current, of sums running into four or five millions, when authorized by recognized mining experts and organizations of world repute,

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would be a pertinent pointer suggesting if not the ultimate success of a project, at least the faith of its sponsors.

The shares of such undertakings as these—and they are not confined to gold mining—may reasonably be given something approaching an investment standing, where the obvious prospects are satisfactory enough. And if there is a word of warning to be given here, it is that the market valuation of such shares often discounts the start of production and payment of dividends to a surprising degree. The potential holder of these issues should ask himself: What must these shares pay to yield me x per cent?—and should endeavour to ascertain the chance of earnings being sufficient.

When Low-grade Mines are Attractive

ANOTHER cardinal factor affecting mining, particularly gold mining, is the question of the effect of variations in the price of gold, costs, etc., on mines according to the grade of ore they mine. As a generalization and over-simplification, we might say that it costs a company as much to mine a ton of low-grade ore as to mine a ton of high-grade ore. Obviously, however, the one is worth less in terms of gold content than the other. For this reason, a low-grade mine is particularly vulnerable to rises in working costs; indeed, at times costs may rise to a level which makes it uneconomic for a low-grade mine to continue mining part or all of its concession. This generally happens in an inflationary era, such as we have witnessed in recent years, and in such an era low-grade shares are an indifferent holding. On the other hand, in a deflationary period, when costs are falling, a low-grade mine may be put on the map again. Similarly, a rise in the price of gold may give a new lease of life to a mine which had formerly been unprofitable. For this reason, if and when the price of gold is raised, it is the low-graders on which the speculator will concentrate. The expected short-term benefits do not always accrue, for a mine may cease milling higher-grade ore in such circumstances to concentrate on low-grade reserves which have suddenly become worth while; but even in such a case the long-term worth of the property in monetary terms has obviously been increased. Randfontein, with its average values of around 3 dwts., is usually instanced as an example of a low-grade mine; Blyvooruitzicht, at the other extreme, with its 14 to 15 dwts., is a very high-grade mine.

Investment or speculation in mining shares is ever a changing

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business. An almost abandoned mine may overnight become a bonanza—and the reverse can happen. Developments improve or deteriorate; costs go up or down (generally up nowadays), and ore grade is rarely a perfectly stable factor. Taxation, varying widely from country to country, may put a good mine out of existence or keep a poor one in; prices of metals (other than gold) rise and fall, and with them profit ratios; labour may be plentiful and cheap or scarce and dear; and so on. No mining share can ever be bought and put away for any length of time. In that way much capital has often been lost—though on rarer occasions it has been enhanced.

Mining Finance Houses

FEW of the Rand operating or producing mines are outside the management of one or more of the big finance groups, but to a lesser degree the same thing is seen in other fields. It is often asked if the shares of such finance companies, which for the most part command a comparatively low yield basis, are not more suitable for the long-term investor than those of the individual mining companies. There can be no hard and fast rule. But risks are normally minimized in the shares of finance companies by reason of the wide spread of their interests. The sudden demise of an operating company, with its shares becoming worthless, would not often be calamitous to the controlling company. Finance shares are therefore generally to be considered safer than the general run of individual mining shares. On the other hand, it is normal for an appreciable proportion of their income to be made up of share-dealing profits—an erratic source of revenue greatly depending on the level of mining market activity—and they cannot achieve the occasional glamour of the more speculative shares in the developing companies. But they have their considerable followings—and with reason.

Modern Mining Technique

Now to embark on a discussion of modern mining technique. Millions of years ago, when the earth's crust was cooling, constant convulsions, eruptions and earthquakes were taking place, and to a much lesser extent disturbances still distort the earth's skin. Great upheavals, folding and twisting, took place during those far-off days. The strata or layers are rarely horizontal; there is nearly always a tilt or dip in one direction or other, and varying from 0 to 90 degrees, i.e., between the horizontal and the vertical

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Hence in many places mineral bearing strata which normally would be buried under many feet of earth and rock are found on the surface. These are known as outcrops; it is from such outcrops that opencast coal is mined in this country. The old-time prospector, with his hammer and washing pan, had a sound but unscientific knowledge of geological formations, and most of the first discoveries are due to his patience. But science has come to the aid of the modern prospector, and there is little in the way of geological formation and structure not known to him. Uplift, folding, sheeting and faulting all have their particular significance, while past discoveries permit a number of generalizations regarding mineral deposits in certain geological periods.

Whereas in olden times prospecting was largely confined to mountainous regions, where outcrops were likely to be exposed by erosion, nowadays the science of geophysics has come to our aid. One of the first instruments used, particularly in detecting magnetic iron ore deposits, was the dipping needle, but more recently very costly and elaborate apparatus has been invented. Given the right geological formation it is now possible to determine the location of mineral deposits at great depths with surprising accuracy. Where only limited capital is available, or where conditions are apparently favourable, the old-fashioned pick-and-shovel surface methods will no doubt continue to be employed. Such old, long-tried methods will still be used, but it is the public company with ample financial resources which in future will make the most important discoveries. Electric conductivity, radio activity and radar have all played their part in assisting the modern prospector in his discoveries.

Where any hopes of any major discovery are entertained, prospecting nowadays almost invariably means a geophysical survey. The three most important systems which have been so far used are the electrical, the gravimetric and the magnetic methods. In the main geo-electrical methods, of which there are a variety, depend primarily upon the varying electrical conductivity between different ore-bodies or rock formations. Usually it has been found that the application of these methods is more successful in indicating the presence of massive metalliferous ore bodies having a high electrical conductivity than in delimiting such occurrences as narrow gold-bearing quartz reefs. It would appear, moreover, that these methods quickly lose their effectiveness at depths of more than a few hundred feet. Gravimetric methods, which employ either a torsion balance or a

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gradiometer, and which are slow and expensive compared with other systems, are employed to conduct gravity surveys from which structural information can be obtained, rather than to enable the disclosure of comparatively small metalliferous deposits.

In the solving of geological problems magnetic methods probably have the greater variety of applications. Here, the problem is one of measuring the magnetic intensity of the earth's crust at chosen intervals and noting the deviation, if any, from what would normally be expected from the surrounding region. Such differences, such "magnetic anomalies", will provide much valuable information concerning the geology of the area.

Geophysical Methods not Infallible

It should not be thought that any of the geophysical methods provide infallible means of discovering new ore bodies, whether gold-bearing or otherwise. But they can and often do give firm indications of the nature of any particular geological problem, and by so doing may prevent waste of expenditure on unprofitable drilling and provide sounder indications of where drilling can be best undertaken. Comparatively recent examples of this have come from the Orange Free State, where gravimetric and magnetic surveying together successfully indicated where drilling was most likely to give profitable results; and more recently still in Nigeria, where geophysical prospecting over areas containing lead-zinc deposits was the forerunner of a drilling campaign that gave interesting results early in 1949. Finally, it should be emphasized that however important may be the indications obtained from these methods, geophysical surveying itself can never do more than indicate the *existence* of mineralization. It cannot suggest the *extent* of that mineralization, and thus there must always be the possibility of disappointment should subsequent work disclose only an extremely low-grade ore body. That is why it is inadvisable to proceed on the results of a geophysical survey alone, hopeful though those results may have been.

Once prospecting parties have ascertained the presence of mineral deposits, options are usually taken on the area under which lies the reef or lode, and preparation is made to drill boreholes to discover whether the deposit is of sufficient value to justify mining. Boreholes will also give an indication of the dip and strike. The dip is the angle or slope at which the vein

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or reef is tilted, whereas the strike is the lateral direction of the reef as measured at right angles to the dip. An ordinary dinner plate buried at an angle in earth would serve as a very fair illustration of a lenticular vein formation. The edge of the plate nearest the surface would be the strike, and the angle at which it is buried would be the dip. The earth above the plate is the overburden; that immediately touching the upper surface, the hanging wall; and that immediately below, the footwall. A rather more apt picture of vein formation will be given if one imagines that the plate has become broken and twisted after burial. A break in the plate would represent a fault in the reef, and in mining much labour and expense is often expended in relocating the reef after a fault has been encountered. Reefs or veins often pinch out on both the strike and the dip.

The Rand in South Africa is unique for uniformity of distribution, which explains why the lives of the mines working the several gold-bearing reefs in that area can be estimated with relative accuracy. Our description of mining operations relates primarily to conditions similar to those ruling in the Rand goldfields, in view of their major importance to mining shareholders. Where geological conditions are different, mining methods may be different also.

What Boreholes are For

PRIMARILY the object of a succession of boreholes will be to obtain as complete a picture as possible of the actual occurrence of a metalliferous ore body. But the probable nature of the deposit will in the first place dictate the sort of drilling campaign likely to be undertaken. In searching for comparatively narrow quartz or banket formations, such as are usually encountered in gold mining, the siting of boreholes will be designed primarily to obtain information concerning the strike of the lode or lodes, the extent to which it "carries down" at depth and, as an important incidental, the degree of faulting or folding or the intrusion of those "foreign" rocks known as dykes. Other valuable information such as the underground temperature of rocks which, as in the Orange Free State, will have an important bearing on underground mining conditions, may be derived from drilling operations.

Apart from the Orange Free State, where drilling programmes of this sort have claimed particular publicity in recent years, another excellent example is provided by the Far Western Rand, where what has become known as the West Wit line, extending

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for some thirty miles, has been disclosed both laterally and at depth by intensive drilling methods. These are the sort of boreholes which from time to time hit the headlines with news of exceptionally high gold assays, but there are also cases like the establishment virtually by boring alone of the mineral reserves of the Northern Rhodesian copper fields. This was possible on account of comparatively regular dissemination of the metal within the ore body.

But from the speculative market angle it is without doubt mainly the drilling for gold, with occasional sensational strikes, to which most interest attaches. And in this context it is impossible to over-emphasize the importance of considering borehole results as a whole. Much importance also attaches to the actual assay values obtained from the cores pulled up in these holes. These assays, taken together, may provide a reasonable expectation of what sort of grade may ultimately be found to exist. But when it is remembered that each individual core, which is no more than an isolated reef sample, is only two inches or so in diameter, and that its gold value is then expressed as so many pennyweights *per ton*, it will be appreciated that the actual metal content in that core must be almost infinitesimal, whatever grade may be calculated from it. Over a given area, where a number of reef intersections have been made by boreholes, the most that can be done to obtain any idea at all of the average grade is to take an average of the results. This should be obtained by the introduction of the inch-dwt. in the case of gold, silver and other rare metals, and the foot-lb. with such ores as those containing lead, zinc and copper. The inch-dwt. (of which more anon) is a notional unit obtained by multiplying the width of the ore body in inches by the assay value in pennyweights. To obtain the true average of, say, four borehole intersections the four inch-dwt. figures should be added together and the result divided by the sum of the respective widths. To divide the total of the four assays in pennyweights by four would provide an arithmetical mean, but this would be incorrect, since it would have taken no account of varying widths.

When sufficient drilling has been accomplished the results viewed as a whole may well prove encouraging enough to justify shaft sinking and initial development. But it should be realized that no accurate assessment of a property's potentialities can be made until the actual business of underground mining has got well under way. In times of "borehole booms" this point is frequently ignored.

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How Diamond Drilling is Done

As already hinted, the borehole is of relatively small diameter, varying from about $1\frac{1}{2}$ to 3 inches in the case of prospecting for mineral deposits such as gold; rather larger diameters are usual in the oil industry. Many types of drilling bit have been developed during past years, from the Empire drill, powered by a horse walking in a circle, and used in placer prospecting, to the power-driven diamond drill now most commonly used for deep boreholes. Most holes are drilled vertically, although the diamond drill can be used at any angle. In actual practice, boreholes are rarely vertical throughout their length, as various obstacles are sufficient to cause slight deflection which in deep holes may attain considerable proportions. Deflections can be gauged by the use of special instruments; otherwise it would be difficult for the prospector to know the location of his drill in relation to the surface. The average deviation from the vertical varies from about 2 degrees in a 500-ft. hole to as much as $22\frac{1}{2}$ degrees in a 6,000-ft. hole. A deflection of this magnitude is equivalent to a horizontal distance of nearly 600 feet. Boreholes can also be deflected with intent by the use of a special wedge, which, dropped into the hole, will cause the drill to take another direction. Deliberate deflection is generally used to obtain more than one sample of the vein so as to strike average values, and this policy has been very frequently pursued in prospecting the new Orange Free State fields.

Cutting by diamond drill requires rapid rotation, speeds varying from 1,000 to 5,000 revolutions per minute according to the nature of the rock being penetrated and the size and depth of the hole. Water is pumped to the bit under pressure to wash away sludge and lubricate the cutting edge. Drilling rates involve so many variables that only approximate figures can be given. Hard rocks drill slower, but require high speeds; soft rocks drill faster, but require slower speeds. Much depends on the skill of the operator. The bit needs to be renewed at intervals, the average life varying between 200 and 600 feet. This necessitates the removal of the drilling rods, a lengthy job when the hole reaches great depths. For a hole a mile in depth (5,280 feet) eight to ten hours would be needed to change the drill. Figures given by a South African mine in regard to a drilling campaign involving 245 holes of an average depth of sixteen feet show an average rate of one and one-third feet per hour of drilling time. This rate would be considerably less when drilling at depth.

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The cost of diamond drilling is high, although no exact figures are available, and in fact averages would be unreliable, as no two boreholes are alike; something in the region of 10s. to £1 per foot would be a rough guide. Cementation of broken formations would naturally add to the cost.

Drilling bits are specially designed to enable a core of the strata being penetrated to be taken, which allows the engineer to make an assay of the value of the ore in the reef. This is of necessity only approximate, as it will be appreciated that to estimate the assay value of a ton of ore in dwts. per ton from a core of a pound or so in weight is extremely difficult, and if the strata is friable, as in the case of the Basal Reef in the Orange Free State, the assay is even more liable to error. Hence sometimes deflections are made so that more than one core can be taken from the reef.

Samples taken from borehole intersections are of the utmost importance to the prospecting engineer, as they enable him to get an approximate idea of the mineral content of the reef. The word approximate is used because of the relatively small quantity of mineral bearing rock contained in a core sample. Assuming a reef width of 30 inches, the weight of the core, probably only an inch or so in diameter, is at the most only a few pounds. In consequence, the mineral content, particularly in the case of gold, may be measurable in fractions of a pennyweight. A pennyweight, usually written "dwt.," is a twentieth of an ounce of gold, so that although scrupulous care is taken in assaying or valuing this quantity of gold contained in the core, even a tiny margin of error is magnified enormously when estimating the gold content of a ton of ore.

In order to have a basis of comparison—and as reef widths vary considerably—it is usual when borehole results are announced to state "inch-dwt." figures. This is the result of multiplying the number of dwts. to the ton of ore by the width of the reef in inches. For instance, 10 dwt. over a width of 30 inches gives 300 inch dwt. From these figures it is comparatively easy to estimate the value of one ton of ore. With gold at 172s. 3d. per fine ounce, 1 dwt. is worth not quite 8s. 7½d.—8.6125s., to be exact. Hence with ore assaying 10 dwt. to the ton the value of one ton of ore would be ten times as much, or 86s. 1½d.—just half an ounce of gold to the ton of ore, it will be noted, since there are 20 dwt. to the Troy ounce used for weighing gold.

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Reefs of the Rand

ON the Rand the reefs, of which there are a number of economic importance, are in succession from the surface downwards as follows: Black, Ventersdorp, Contact, Kimberley, Bird, Livingstone, South, Main Reef Leader, Main, and Government. Not all these reefs are necessarily gold-bearing at all points, nor are they always present. In the Orange Free State a number of reefs have been found, the most important of which, economically, will certainly be the Basal Reef.

Reef widths vary considerably from a few inches up to several feet, but usually the richest ore is found in the narrow veins. On the Rand proper, the average width is around twenty-six inches. Where the reef is narrow, considerable amounts of barren rock will need to be excavated in order to allow the miner sufficient room to work. The minimum width is about forty inches and is known as the "stopping width". In the event of barren rock on either side of the reef having to be cut away it is usual to sort out as much as possible underground in order to avoid hoisting too much waste material, the waste being used to fill up the worked stopes.

The width of the reef as given by the borehole intersection is therefore an important factor to be noted when assessing the value of a "strike", as there will be lower operating costs if every ton of material hoisted to the surface is ore-bearing.

However, the inch-dwt. figure does give a good basis upon which to compare the relative values of various borehole samples; thus, 20 dwts. over 20 inches is of exactly the same value as 40 dwts. over 10 inches. With a stopping width of 40 inches, 400 inch-dwts. will give a "yield", "recovery" or "extraction" of 10 dwts. to the ton of ore, or ore and barren rock, extracted. It remains equally true, of course, that, to take a theoretical example, 1 dwt. over 400 in., though providing an equally impressive inch-dwt. figure, could never be payable in any circumstances other than a fantastically higher price for gold or an equally improbable low level of working costs. Thus, though inch-dwts. are an invaluable unit for comparative purposes, it should always be remembered that they are nothing more than that.

Once it has ascertained by a planned series of boreholes the strike, dip, width and possible value of the underlying reef, the next step to be taken by the company financing the prospecting is to arrange for the flotation of one or more companies to exploit

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the area. A long time, maybe years, will elapse before production can be made on a profit-making scale, and a good deal of money will be required. Housing and offices for the staff, machinery, drills, blasting equipment and electric power are but a few of the essentials.

The first operation is to sink a shaft in the most suitable position. This may be vertical and sited so that it will intersect the vein at a certain level, in which case crosscuts will be made to the reef at points above and below the intersection; or it may be decided to sink an incline shaft in the footwall of the reef, or actually in the dip of the reef. The accompanying Figure 1 will make this clear. The vertical shaft avoids excessive footage, but its position in the hanging wall may make for instability, while long crosscuts may be necessary. In good ground an incline shaft in the vein or footwall develops the maximum length of reef for a given footage, while the position in the footwall makes for maximum stability.

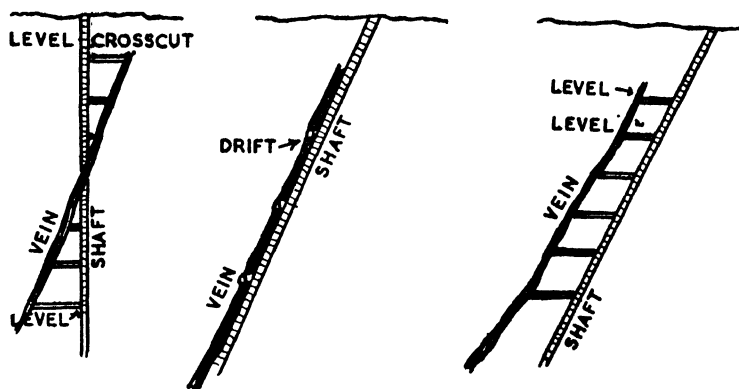


FIG. 1.—Shaft positions relative to the vein: A vertical shaft (left) and two types of incline shaft.

The method to be used is conditioned by the material that must be excavated and supported, and precautions must be taken lest water in considerable quantities be encountered. Many different methods of shaft sinking are used, including drilling and blasting, sheet steel piling and excavating, open caisson and hand excavation or boring. The most usual in the case of hard rock formations is machine drilling and blasting. It is a slow and laborious job. After blasting, the broken rock has to be cleared and hoisted to the surface, while timbering follows the excavation from ten to fifty feet distant. Each blasting

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operation necessitates clearing all men and tools to the surface, and as the shaft deepens so the rate of sinking drops. If water should be encountered, it may be necessary to resort to cementation—a process of injecting liquid cement under high pressure into cracks and crevices, thus sealing them off.

High Cost of Shaft Sinking

ALTHOUGH usually continued throughout the twenty-four hours, the rate of shaft sinking is slow, varying between one and three feet per day. Costs are high. Many varying factors make it practically impossible to state them with any degree of accuracy, but they may be something between £5 and £20 per foot according to the cross-section. The shaft may be of almost any shape, rectangular, square, elliptical or circular, and is arranged to allow for several different compartments. Two skip compartments will be needed, one hoisting, the other returning; one or more cages with counterbalances; pipeways, manway, etc. Powerful winding machinery will have to be installed at the head of the shaft to handle the large quantities of ore that will be hoisted from the lower levels.

With the shaft driven to the desired depth, the next step in development is to drive levels or crosscuts to the vein. These are usually of sufficient width to allow of a small gauge track being laid for the use of trucks carrying the ore to the level station whence it is hoisted to the surface.

Where the crosscut enters the vein a drift will be driven. This is a narrow tunnel which follows the course of the reef in a horizontal direction. The vertical distance between the drift will vary from 50 to 300 feet, but the most usual distance is 100 feet. The distance between drifts will depend largely on whether ore continuity is thought likely or not. If continuity is well established and greater spacing is possible, development costs can be lowered considerably, as fewer stations will be necessary.

At regular intervals along the drift, further tunnels, known as raises and winzes, will be driven. A raise is a small shaft cut from the drift upward through the vein to the next higher drift. A winze is a shaft sunk from a drift through the vein to the drift on the next lower level. Raises are most common, as there is no need to hoist the ore from the tunnel as with a winze. As the ore is excavated from a raise, it is allowed to fall to the lower level, where it can be loaded into trucks and taken to the shaft station.

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Where continuity of the reef is established raises are driven at distances of between 200 and 300 feet along the drift, and thus a block of ore is established of a length varying according to that distance and of a depth according to the distance between levels.

Winzes are sunk below a given level in order to test whether the ore values justify another level being opened out. From them drifts are sometimes driven, and if the results justify it the main shaft will be sunk to that level and another station established. Figure 2 illustrates this.

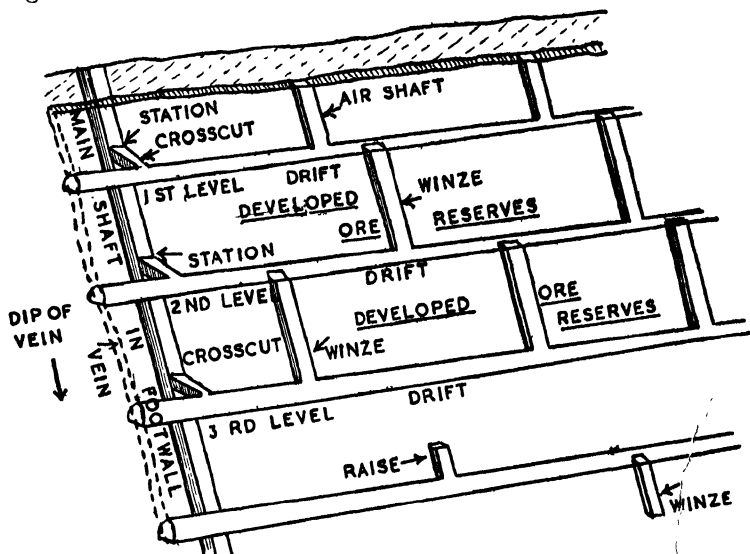


FIG. 2.—Development on an inclined vein.

As development by driving drifts, raises and winzes proceeds, samples are taken at every few feet and the results give the percentage of development footage which is payable, i.e., contains sufficient mineral per ton of material to give a working profit. The percentage of payable ore in relation to the total footage sampled is an important factor affecting the value of the mine, and is termed its payability.

Estimating the Ore Reserves

With the samples available it is now possible for the engineer in charge to estimate the total tonnage of ore so far developed. This is known as the ore reserve. Ore reserves are calculated over the stope width, not the reef width—unless this is the same or greater

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than the minimum stoping width. The ore reserve figure is usually divided into "ore available" and "ore contained in safety pillars, etc., not at present available". The latter is only mined when the other part of the mine is worked out.

Before production and milling can begin on a scale sufficiently large to justify some reward for the people who have financed the expensive development costs, it is necessary to develop sufficient ore reserves to provide the mill with material for a few years' operations. Development of the mine will continue without cessation throughout its life in order to maintain the ore reserves at a figure sufficient to cover two or three years' working.

A "stope" is really any underground excavation made for the purpose of removing ore; the shape and outline depend on the thickness of the reef or vein. "Stoping" is the act of mining the ore, and includes all the operations necessary for the excavation of the material to be sent to the mill.

Milling consists of breaking down the lumps of ore, firstly by giant jaw crushers and secondly by stamps. The latter are a series of huge hammers constantly falling on to the material in the stamp boxes. With water the ore is turned into a fine mud which is passed over copper plates coated with mercury, with which the gold amalgamates. Subsequently the mercury is evaporated, leaving the gold as residue. After passing over the copper plates, there is still some gold left in the crushed ore, which is then taken to the tube mills wherein it is ground still finer. Thence it goes to great tanks, where cyanide of potassium is injected which dissolves the remaining particles of gold. When drained off the solution is passed over zinc filings on which the gold is deposited. The final operation is to heat the zinc until the gold is obtained in its pure form. A modern practice is to eliminate the stamps and send the ore direct to the tube mill to be ground in cyanide solution.

Because lode or reef mining, such as that on the Rand described above, requires great capital resources, it has inevitably figured more prominently in the gold share market than any other form of mining. Broadly speaking, copper and zinc-lead-silver ores are mined by similar methods, though, of course, the subsequent metallurgical treatment varies. The hyphenation of the last three

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items serves as a reminder that these often occur in association in the same ore bodies. Lode or reef mines which can be exploited by adit mining—driving level or nearly level tunnels into hill-sides and the like—are often relatively cheap producers, with no expensive shaft sinking.

Modes of Alluvial Mining

ALLUVIAL mining can sometimes be effected with small capital resources—that is why so many gold rushes were based on the discovery of alluvial deposits—but nowadays it is customary for large-scale exploitation of alluvials to make use of colossal dredging machines, such as those used in the tin industry of Malaya, which eat their way into surface deposits, e.g., in the bed of a river, and can move on to new ground as desired. One Malayan company's fleet of dredges cost over £700,000 at pre-war prices.

Dredging areas will usually have a comparatively short life, especially where large capacity dredges are using up a deposit, so that here again a prospective purchaser of shares must be particularly careful to recognize that he will be buying a wasting asset. Where water is plentiful hydraulicking is sometimes an effective way of treating alluvial deposits, which by this method are broken down by high-pressure water jets working somewhat on the principle of the fireman's hose.

About one-fifth of the world's gold still comes from alluvials, but the proportion was much higher in the past. As alluvial deposits are used up, lode mining will almost certainly become more important in the production of tin, but at present about 70 per cent of the world's tin comes from alluvials. Cassiterite, or tin oxide, occasionally mentioned in dredging companies reports, is virtually the sole source of metallic tin.

Alluvial deposits are generally river gravels and the like close to or at the earth's surface. To be of commercial value they must contain payable quantities of such heavy ores as cassiterite, or native gold, or platinum. Weathering of surface deposits of this type tends over a long period of years to concentrate the heavy ores separately from any lighter associated material. The financial history of many alluvial enterprises is erratic, but sampling the

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deposits, since they are virtually on the surface, is a relatively inexpensive operation. It is usual to express values, costs, etc., per cubic yard in dredging practice.

To sum up—this chapter on mining shares (as also the following three chapters on oil, rubber and tea shares) deals with various outlets for the investors' funds which for the most part demand unceasing vigilance in watching day-to-day developments in the individual properties concerned and also in regard to quickly changing conditions in the relevant prospecting and exploitation processes. In many cases mining shares, oil shares and the like carry very substantial risks, but equally substantial rewards are possible, given reasonably good luck.

CHAPTER VI

OIL SHARES AND THE OIL INDUSTRY

Changes in oil prospects—Trend of share prices—Some major companies—Opening up Middle East fields—Importance of politics—Details of world oil production—Petroleum price structure—Oil exploration technique—A speculative business—Need for more refinery capacity—Various refining processes—Replacing wasting assets.

AFTER only a temporary slackening of requirements at the end of the war, the emergence of an apparently insatiable demand for oil fuels and products, with attendant considerable price increases, enhanced the status of oil shares, and until the middle of 1948 the prospect was held to be wholly bright. The achievement, in an unexpectedly short period, of equilibrium between supply and demand in the United States has led, of necessity, to a revision of this view. And it has tended to emphasize the great gulf fixed between the big oil combines with their multifarious ramifications all over the world and those other oil companies which are purely producers of crude oil, and which have no refining or marketing facilities within their own organization (or at any rate only limited interests of this kind). More speculative still are the non-dividend payers, where in many cases buyers have been discounting the future very considerably and backing their opinion of what the drill may find. The major part of the oil share market can be grouped under these three headings.

Largely because one-fourth of the world's power supplies is derived from petroleum, besides most of the lubricating oil so essential to industry generally, the world's petroleum consumption rose over 70 per cent between 1938 and 1949. Commercial refining and transport facilities fell much into arrears owing to the war, and it must be several years from 1948 before the position is properly balanced in this respect; but the present situation demonstrates the fact that in regard to the supply of crude oil itself there is no need for disquiet. If this implies static or even declining crude oil prices, the refiners can face such a situation to more advantage than can those concerned only with crude oil production. And doubtless it is the refiners

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that will mainly benefit if theoretical long-term forecasts of world oil demand prove sound. Such forecasts (excluding U.S.S.R. as usual) put daily average world demand at 11,192,000 barrels by 1953, against 8,822,000 in 1948. Seven barrels are roughly equal to a ton.

The trend of oil shares has been encouraging for many years past. Even in the five-year bear market which ended in 1940 THE INVESTORS' CHRONICLE index number for oil shares (December 31, 1923=100) was far above the general index number for commodity shares; and with the upturn in the market that continued for the next seven years the buoyancy of the oil-share index was still pronounced when compared with that for commodity shares as a whole, or indeed with that for stock market securities in general. By December, 1948, the oil-share index still stood at 329.0, though its peak in the seven-year bull market had been 369.1 in July, 1947. The wholesale re-casting of Stock Exchange values in the early months of 1949 brought the index back to 275.9 at the end of April, however—a drop of 16 per cent from the end-1948 level, which is roughly in line with the fall shown by the combined index for all commodity shares. Yields on the major oil shares, which had long tended to discount the admittedly promising prospects, have consequently risen and, in a section of the stock market where dividend yields of under $3\frac{1}{2}$ per cent were common, few of the main companies gave under 4 per cent in mid-1949. In most cases there was a big surplus of earnings over dividend rates in 1947 and 1948, but dividend limitation keeps payments down.

Some Leading Oil Companies

THAT large capital outlays are necessary in the oil business is emphasized by the fact that though London Stock Exchange interest is confined to about two dozen companies, many of these are very large undertakings.

The Royal Dutch-Shell group, with 40 per cent of the operating companies' capital held by Shell Transport and 60 per cent by Royal Dutch, is a very broadly based organization which is likely to show great expansion over the next few years. In 1948 it produced around 10 per cent of the world's crude oil. (One-eighth of the world's output was produced by British and Anglo-Dutch companies outside the United States of America.) While the Royal Dutch operating interests are identical with those of Shell, the shares are less attractive to British holders than Shells

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because of such complications as special Dutch company taxation and the like. The group raised £64 millions of new money at the end of 1947 and carried out a major dollar financing for oil development in the Caribbean area by raising \$250,000,000 in New York in October, 1948. Royal Dutch announced in February, 1949, the completion of arrangements for the borrowing of Fl.100 million from financial institutions in Holland. Acquisition of the minority interests of VOC has also called for the creation of fresh capital by Shell. Consolidated earnings of the group were first disclosed in respect of 1948. After depreciation and contingencies provision they were no less than £44,565,000 for the year, of which £17,826,000 accrued to Shell Transport and £26,739,000 to Royal Dutch.

Anglo-Iranian Oil is another undertaking of this type. Like Shell it has lately entered into close alliances with its American opposite numbers in connection with oil development in the Middle East. Anglo-Iranian produced about 5½ per cent of world output in 1948. There is every prospect of a great increase in its production over the next few years, and a twenty-year life for the fields even from existing reserves has been suggested. But the political angle is particularly important with Anglo-Iranian. Its main properties are very close to Russia's sphere of interest in the Middle East, and the Persian Government shows increasing vigilance in protecting its own interests in the oil business, and in increasing its demands for royalties.

Burmah Oil is almost a major oil investment trust by reason of its large holdings in Anglo-Iranian and Shell. The shares are usually well worth their price on those holdings alone. Projects for the resuscitation of the company's war-damaged properties in Burma were recently taken a stage further by the Burmese Government's suggestion that the rehabilitation might be carried out by a joint venture between the Government and the company for the continuation of the work with public finance. But the unsettled state of the country continues to be a major factor.

Canadian Eagle is in a strong position with its widespread interests, mainly in Latin America and in this country, in production, marketing and transport. In the latter part of 1948 no less than £9,000,000 of new money was raised by a new capital issue—another example of current enormous outlays in the oil business, for the Canadian Eagle group's net assets at the end of 1947 were already nearly £23,000,000. This group works in association with Royal Dutch-Shell, and any further rehabilitation of the allied Mexican Eagle might help it materially.

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Outstanding in the Trinidad group is Trinidad Leaseholds, which has a good earnings record and a strong financial position. It is interested in the refining as well as the production side of the industry, and has lately strengthened its marketing organization in the U.K.

The interests of British oil investors in South America were notably modified by the absorption by Anglo-Saxon Petroleum, one of the main operating companies of the Royal Dutch-Shell group, of the publicly-held shares of Venezuelan Oil Concessions, a remarkably prolific producer that has shown fine earning capacity for many years past. Resentment at this move may have been premature, in view of the less propitious outlook for Venezuelan producers, whose production costs are likely to be high in relation to those of the developing Middle East producers.

Most of the non-dividend payers are extremely speculative. This was well brought out by the experience during 1948 of Ultramar. This is a Venezuelan proposition under most influential management and backing, and upon it many millions are being spent. It commenced to deliver oil in June, 1948, but it subsequently transpired that production from the wells was a good deal less than originally anticipated and that substantial amounts of new capital would be needed. As a result, the 10s. shares fell within a few months from a "high" for 1948 of 85s. to under 25s. The incident serves as a reminder that while oil companies can and do "strike it rich" not even the finest backing and management can take the risk out of what must be essentially a speculation. In this case results were disappointing in the early stages of production despite the fact that at 31st December, 1948, one hundred and seven wells were in production—a fact in itself implying very large expenditure.

World Oil Supplies

It was typical of the rapid change-round in the world oil situation at the beginning of 1949 that, as soon as it became apparent that United States domestic production was surplus to requirements—a result, incidentally, of an unexpected contraction in demand for certain fuel oils rather than an excessive increase in production—a plea for a reduction in imports to the United States was voiced by the oil producing states of Texas, Kansas and Oklahoma, as well as by the Independent Petroleum Association, on the ground that "a flood of foreign oil" was jeopardizing national economy and security. So much for the widely held

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opinion that the United States was becoming an increasingly large net importer of oil products—though we have to recognize the existence of a powerful propaganda element in statements made on behalf of United States domestic oil producers. Post-war production has been stepped up on the assumption that the demand for petroleum products would continue to expand over the long term, and any cutting back in production outside the United States in consequence of what may well prove to be a temporary setback in that country's consumption might bring retribution in the form of another shortage at a later date. Matters are still, at the time of writing, at an indecisive stage, but it is likely that more competitive conditions in marketing and distribution have arrived to stay. While the United States has now more crude oil than she needs, having in fact cut production from the high level of 5.69 million barrels per day in December, 1948, to around 5.3 million barrels a day in the spring of 1949, the plan for European economic recovery assumes an increase in Europe's needs of petroleum products from the 1947 level of 268.8 million barrels a year (against 210 million barrels in an average pre-war year) to 436.8 million barrels in 1952, in token whereof the participating countries, chiefly the United Kingdom, France and Italy, have embarked on an extensive programme of expansion of refinery and other facilities. In view of the change in oil prospects since these and other expansion programmes were conceived, and of the fact that some of the necessary expenditure would be provided by Marshall aid dollars, it would not be surprising to see some pruning of the plans. But in many cases American and European oil expansion plans have interlocked since the war ended (as an example we might quote various close alliances in the Middle East between American, British and Anglo-Dutch undertakings), and so it seems likely that a review of American oil expansion plans will have to be an integral part of any scheme to make sure that over-optimistic expansion does not create an excess of refining capacity a few years hence. Generally speaking, the short term prospect depends on the reaction on crude oil prices. If the voluntary action being taken by the main United States producers in restricting output serves to maintain crude oil prices at their present levels, profits, though adversely affected by lower production, will be better able to supply the funds needed for continued exploration and development. With the U.S. better placed than ever to curb excessive oil production, we have an important steadying factor in the world oil outlook.

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What the effect of the turn-round will be on plans for the opening-up of the fields in Arabia and the expansion of production in Persia and Iraq also remains to be seen. Suffice it to say that the completion of the thousands of miles of pipelines and the additional tanker fleets is a much less urgent matter than it seemed at one time.

We must not forget the all-important political angle. Recurrent acrimonious exchanges between the Russian and Persian Governments on the question of oil concessions in Northern Persia provided one reminder of the extent to which international politics override oil prospects. That is only one instance supporting the axiom that oil and politics are inextricably intermingled. One reason for this is that, generally speaking, the nationals of oil-bearing territories have only taken a slight part so far in their exploitation. Of course, the outstanding exception to this otherwise accurate remark is the great American oil industry—exploited by American citizens in an overwhelming majority. But if we turn to South America we find American, British and Dutch companies running various oilfields, sometimes in partnership; and in the fast developing fields of Arabia we find the United States top-dog again. In Iraq, Persia and Burma, and probably also in Trinidad, British companies excel all others, while in the Netherlands Indies the Dutch interests naturally predominate, with the British also concerned through the Royal Dutch-Shell group.

Major Oil Producing Countries

THE tremendous, and now apparently successful, efforts of the crude producers to beat the world oil shortage can be gauged by the 13.8 per cent increase in the 1948 world production over the 1947 figure, itself a record, of 414 million tons. The output of 471½ million tons in 1948 seems likely to stand, at least temporarily, as a record in view of the cutting back of production in certain of the American oilfields in the early months of 1949. The further big rise in the 1948 output was due almost entirely to the major oil producing countries, for nearly all the increase came from the U.S.A., Venezuela, Russia and the Middle Eastern countries. The record output secured by the U.S.A. itself was only obtained by bringing yields from individual wells to something near the maximum efficient production rate.

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CRUDE OIL PRODUCTION—IN MILLIONS OF METRIC TONS

	World	Outputs, major producers			Per cent of world output		
		U.S.A.	Venezuela	Russia	U.S.A.	Venezuela	Russia
1938	271.6	164.1	26.9	29.7	60½	9½	11
1939	285.1	178.8	29.3	30.5	63	10½	10½
1940	293.0	182.7	26.6	31.0	62½	9	10½
1941	305.0	189.7	32.6	—	62	10½	—
1942	285.0	187.2	21.1	—	66	7½	—
1943	312.0	203.1	25.6	—	65	8½	—
1944	346.3	226.7	36.8	18.0	65½	10½	5½
1945	356.1	231.5	46.4	20.4	65½	13	5½
1946	376.5	234.2	56.7	22.8	62½	15½	6½
1947	414.1	250.8	63.5	27.0	60½	15½	6½
1948	471.3	276.9	69.7	30.5	58½	14½	6½

Outputs of Remaining Important Producers

	Saudi Arabia				Iraq	Dutch E. Indies			Mexico	Rumania
	Bahrein	Kuwait	Persia							
1938	0.1	1.1	—	10.4	4.4	7.4	5.5	6.6		
1939	0.5	—	—	10.4	4.0	7.9	6.3	6.2		
1940	0.7	—	—	9.3	2.6	7.9	6.5	5.8		
1941	0.6	—	—	8.0	1.6	0.9	6.4	5.5		
1942	0.6	0.8	—	9.9	2.6	1.2	5.0	5.7		
1943	0.7	0.9	—	10.3	3.6	2.5	5.1	5.3		
1944	1.1	0.9	—	11.5	4.3	4.4	5.5	3.5		
1945	2.9	1.0	—	17.0	4.7	1.1	6.1	4.6		
1946	8.2	1.1	0.8	19.5	4.7	0.3	7.0	4.5		
1947	12.2	1.3	2.2	20.5	4.7	1.1	8.0	4.1		
1948	19.3	1.5	6.4	25.0	3.1	4.2	8.4	4.5		

The accompanying table brings out well the overwhelming predominance in the world's oil output enjoyed at present by three or four leading countries. Over the next few years the main change in this respect is likely to be the forging ahead of production from the Arabian fields, and the further increase in Persia particularly. What may happen in Russia is difficult to gauge. The prospect for Venezuelan producers gives cause for disquiet in view of the large proportion (37 per cent) of output which goes to the United States and, since a further 34 per cent is sold to Europe, the needs of which are expected to be largely satisfied from the Middle East by 1952, further large increases in Venezuelan output cannot be looked for at the present stage, particularly in view of the somewhat uncertain political situation.

In the Middle East there are enormous oil reserves as yet hardly exploited; it is estimated that they amount to half of the world's total proved and indicated reserves. The shifting of the centre of interest in oil production potentialities to the Middle East has been a prime factor in recent years. Apart from Persia, where production is of long standing (big fields having been

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opened up as far back as 1908), and Iraq, where the growth of output has been a matter of the last twenty years or so, the Middle East fields have yet to show what they can really do. But over the next few years (assuming a permanent solution of the Arab-Jewish problem) we are going to see very large increases in production from fields which at present are still relatively minor factors in world oil outputs, such as Saudi Arabia, where commercial production began in 1937, and Bahrein and Kuwait in the Persian Gulf. It seems likely that Kuwait's production will reach 12 million tons per annum perhaps even for 1949. Judging by developments reported early in 1949, the oil possibilities in Egypt, or at any rate in the Sinai Desert area thereof, are greater than had been appreciated.

British Borneo's advance in production from 300,000 metric tons in 1946 to 1,826,000 metric tons in 1947 has been one of the outstanding post-war developments; by the end of 1948 there had been another remarkable increase, for the annual rate of production by then was 3,200,000 tons, and the actual 1948 production was 2,870,000 tons. Trinidad produced about 2,900,000 metric tons per annum in 1946 and 1947, and 2,885,000 in 1948. Deep drilling (down to 9,000 feet in one case) is now being employed to secure further crude oil reserves.

United States Dominates Price Structure

PETROLEUM prices all over the world are eventually regulated by United States Gulf prices—those ruling for crude oil in that great centre of gravity for the oil business constituted by the major producing centres (mainly in the U.S.A.) around the Gulf of Mexico and the Caribbean. Tanker freights and other transport costs are, of course, an important factor in the price structure. From July, 1946 to January, 1948 United States Gulf prices rose over 90 per cent in eighteen months from uneconomic war-time pegged levels. While United States wholesale prices as a whole rose 63 per cent between 1926 and the beginning of 1948, crude oil rose only 39 per cent and petroleum refined products only 8 per cent. The falls in the prices of certain products, notably residual fuel oils, seen at the beginning of 1949, have materially affected the prospects, and while at the time of writing the price of crude oil has been little affected the altered statistical position hardly favours further price increases. Yet the U.S.A. alone consumed more oil in 1948 than the entire world had consumed ten years before. And for petrol, as distinct from the heavier products, the prospect still pleases.

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Petroleum in commercial quantities is by no means easy to find, even with all the paraphernalia of modern technology. It usually occurs in underground pools, and the favourable conditions for its deposition mainly rest on the existence of an anticline in the geological strata. That is an upward kink in the strata—call it a saddleback if you like. Geological conditions often have a vital effect on the cost and difficulty of drilling. An instance is provided by Trinidad—difficult geological country. There the footage of drilling involved in oil production is relatively greater, and therefore more expensive, per unit of production, than in many other important producing areas. In Trinidad, companies may have to keep on drilling well after well, to find and tap more or less disconnected pools of oil. There are other more favoured countries—Persia, for example—where the deposits of oil are in such extensive and continuous formations that once located they only need comparatively few wells to secure immense and sustained production, and additional wells are normally only required to increase the rate of flow from the same source. So individual wells can be very big producers.

Oil is not like solid minerals; it does not stay put, but flows to wherever the pressure on the oil body is released by the drilling of a well—be the well shallow, like so many, or as deep as some exceptional exploration wells. So if one operator goes all out to get as much oil as he can every other neighbouring operator has to do the same—and the result is then chaos. Regulations whereby wells must be spaced out and daily production must be limited guard against the bottom falling out of the world crude oil price market.

With oil so fluid the life and production volume of an individual well can vary enormously, and there are many variations in the chemical composition of the crude oil (sometimes even in the same fields) which by themselves can give rise to a multiplicity of refined products. All such factors will influence the price for the oil from a given company's wells.

There is only about a one-in-ten chance of an exploratory drilling being a success. But the income from that one success will normally more than outweigh the cost of the nine failures. Even in an established field there are cases where the well may have to be abandoned because it is unpayable or perhaps has not been drilled in the right position. Chances of this happening are reduced by constantly improving technique, but it is an ever-present factor which helps to stress the speculative nature of the oil business—more especially at the production end. Shares of

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companies which are solely engaged in crude oil production and exploration and which have no assurance of securing the benefits of marketing refined products must always be chosen most cannily.

We could hardly find a better epitome of the speculative risks attending even the soundest oil undertakings than the remarks made by Mr. Kenneth A. E. Moore, the chairman of Trinidad Petroleum Development, at that company's 1947 annual meeting. As he observed: "One can quite understand that the risks are sometimes forgotten because only the successful oil companies survive, but it is a matter of history that Trinidad, like other oil countries, has been the graveyard of many companies and many millions of capital lost in the search for oil. The few that survive deserve and sometimes reap a rich reward, but in the earning of it they make an immensely greater contribution to the community at large." There you have the speculative nature of practically all oil shares in a nutshell.

Need for More Oil Refineries

ONE of the impelling causes of the big new Shell capital issue announced at the end of 1947 was the urgent necessity for this country to have oil refineries in Britain itself which could take advantage of the growing production from the Middle East oilfields, and thus not only save us paying dollars for oil imports but also enable British companies such as the Shell group, which have large refinery facilities in the Caribbean area, including the West Indies, to use those facilities for the production of refined oils. These can then be conveniently sold for dollars. Government approval has been given to an oil refinery construction programme in the United Kingdom to treat 20 million tons a year and to cost as much as £95 million—a figure which might easily increase by the time construction is completed. It is estimated that United States refineries alone will have to add more than 400,000 barrels to their daily capacity by 1951. So many millions will be spent on refineries themselves, cracking plant, special lubricating oil plants and storage tanks by Shell, Anglo-Iranian and other important groups. And in this country growth of the home refining industry (based almost entirely on imported crude oil) should later on help our balance of payments position materially.

The great capital issues made by oil companies during 1948 merely supplemented the provisions made out of profits for

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capital development, such as Anglo-Iranian's £10,500,000 general reserve allocation out of 1947 profits. In the ten years to the end of 1947 the cost of the refinery equipment needed to produce a given quantity of refined petroleum products was about quadrupled—partly because of the more complex processes now employed, but also because of dearer labour and materials.

Crude oil as it comes from the earth is almost always a very crude product indeed, but refining splits up the crude oil into suitable saleable products. There must be thousands of petroleum products, and here we can only name a few—for instance, petrol, kerosene, lubricating oil, fuel oil and bitumen. In coming refinery developments in this country production of chemicals from petroleum will play a big part. Aside altogether from the Shell plans in this connection, the Anglo-Iranian Oil Company and the Distillers Company combined to form an important new undertaking which is to produce chemicals and plastics in this country from petroleum or alcohol. In the U.S.A. three-quarters of the basic material for the important phenol group of plastics comes from petroleum. Even in this country, where indigenous coal will presumably surpass imported petroleum in this connection, petroleum will still be vital to the young industry as a source of raw materials. Large-scale and notable developments are also in hand in connection with Petrochemicals Ltd.—a company exclusively concerned with this chemical side of the oil business. The Catarole process to be worked by this group has been stated to produce nearly one hundred chemicals from petroleum which are essential in manufacturing plastics, synthetic rubber, rayon, etc.

There are two main processes of petroleum refining. Distillation is the process of long standing, but more recently the cracking process has assumed great prominence; it enables much more scientific manipulation of crude oil so as to obtain the desired proportions of refined products. Ever-changing requirements of the market have meant remarkable alterations in refinery technique. For instance, immense fires could be seen in the Netherlands East Indies oilfields in the old days, before the internal combustion engine was a really prominent factor in modern life. At that time petrol was no good to the oil people, for they did not know what to do with the stuff after they had

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refined out the kerosene and similar-products; and so the residues used to be set alight on the fields.

With distillation, more usually called straight run refining, the refiner cannot control to any great extent the proportions of various refined products derived from a given amount of crude oil. The straight run refinery process is conditioned by the type of crude used, and there are very many variations in crude petroleums. From the marketing point of view, the disadvantage of applying straight run refining to any and every type of crude oil is that in order to produce so much petrol as is required nowadays the refiner would willy-nilly have to manufacture huge quantities of other oil products.

With the cracking system came a revolution, for by the application of high temperature combined with pressure it is possible to change the internal structure of the hydro-carbon molecules of the crude oil, and so the cracking process can do something which the straight run process could not—it can, for instance, produce petrol from the heavier fuel oils. This characteristic is clearly very useful in adjusting supplies of various refined products to the fluctuating demand. But it entails some losses of charging stock in the process, and cracking is needed less in periods when demand turns towards heating oils.

Thermal cracking, the process already described as functioning by heat combined with pressure, is now tending to be superseded by catalytic cracking, which operates faster than thermal cracking and is even more flexible, producing greater yields of the desired petroleum products.

That refinery technique has made immense strides in this century and that such strides are continuing is obvious. The fuel consumption of a modern refinery has been brought down to a very low figure, and the main cost of refining arises from the cost of maintenance, the cost of the expert technicians required for operation and research work and the amortization of the enormous capital expenditure. The last fact was driven home by the official explanation of the reasons for the capital expenditure programme contemplated by Royal Dutch and Shell, totalling over £100 million up to the end of 1949. But the big refining undertakings provide massive foundations for the “blue chip” shares in the oil section—holdings possessing notable investment merits—and of the Royal Dutch-Shell capital outlay programme 41 per cent is in respect of oil refineries and chemical plants. It is such big undertakings which carry the smallest proportionate

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risk for investors in this particular section of markets. But with all oil shares we must bear in mind the importance of companies replacing wasting assets—e.g., by constant and expensive new exploration work. And we must recognize the fact that the very nature of the oil business demands, in an uncommonly high degree, the financing of enormous capital developments out of current earnings as far as possible. The 1949-50 Budget indicated that U.K. oil companies may shortly receive rather better treatment in respect of tax allowances for depletion of wasting assets.

CHAPTER VII

THE CHOICE OF RUBBER SHARES

Rise of the plantation rubber industry—A speculative share market—No dividend limitation—Wealth of company statistics—Low denomination shares—The question of marketability—Dividend yields offered—Conditions in Ceylon, Malaya, Dutch Indies—Production and consumption prospects—Importance of synthetic rubber—Companies' need for strong finances—Rubber plantation technique—Budgrafts for low costs and high production.

THE phenomenal progress of the motor industry following upon commercial development of the internal combustion engine was one of the outstanding features of the first half of the twentieth century, and the equally rapid expansion of the petroleum industry and the plantation rubber industry was closely interwoven with it. As the demand for tyres grew, so did the commercial development and financing under European or American auspices of the rubber growing estates in Malaya, Ceylon, the Netherlands East Indies and some other Eastern countries.

Methodical planting of the trees at a definite number per acre, careful tapping of their bark according to pre-arranged systems and a host of other techniques were evolved. For all that, rubber shares are among the most speculative of holdings. But in these days when dividend limitation has been accepted as standard practice by practically all of our British industrial companies, it is worth bearing in mind that rubber shares are also among the few real "equity" shares, since the voluntary limitation arrangements exempt from their scope those companies which suffered damage and disruption during the war. The vast majority of rubber undertakings can claim that the war deranged their operations in one way or another.

With the post-war rubber industry two outstanding matters which must be noted early in this chapter are the importance assumed during the war and since by synthetic rubber consumption, and the increasingly urgent need for replanting old plantation rubber areas.

The U.S.A. consumes nearly half the world's natural rubber production and about nine-tenths of the world's synthetic

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rubber production at the time of writing (1949). In January, 1949, one quarter of the world's total rubber supplies was synthetic rubber. And in the U.S.A. about 60 per cent of consumption was met by natural rubber, and about 40 per cent by the artificial product. Seeing that natural rubber production in Indonesia and Indo-China has yet to recover fully from the effects of the war, the possibilities of a surplus of natural rubber arising from time to time have to be allowed for. Synthetic rubber's production volume may thus tend to control the price of the natural product.

One long-term policy by which natural rubber producers may be able to compete is by replanting their old areas with the highly productive new types of rubber trees which have been evolved. With the effective life of a rubber tree now reckoned at thirty-two years (including seven years of immaturity) the need for rejuvenating estates had been recognized by the best rubber groups long before the war. It is now becoming more pressing. Probably the minimum ratio of trees to be uprooted each year should be $3\frac{1}{2}$ per cent. Allowing for the immaturity periods, this would mean that at least a quarter of an estate would be out of production at a given time. In the end such a policy might reasonably be expected to bring its reward. It is being increasingly recognized that the cost of this replanting should be a charge against current revenue. It might add, say, $\frac{3}{4}$ d. per lb. to costs—more with very old estates.

While the few have made big fortunes out of rubber shares, many, especially the smaller investor with his limited means, too often find the hopes on which shares are bought savour of "such stuff as dreams are made on"; and losing heart, through the adverse trend of prices, they cut a loss just when they should hold on. Yet in few investment spheres is so much information available for forming a sound judgment. Under normal conditions, prices of the commodity are published daily and outputs of companies monthly. The areas of mature and immature rubber are known, also the proportions of "seedling" and "bud-grafted" rubber. Annual reports give clues as to yields of trees and trend of costs, as well as the general policy and quality of the management.

The human factor obviously plays an important role in investment in rubber shares. A wealth of statistical data is available, but purely statistical methods of valuation are far from foolproof. For instance, a low capitalization per planted acre (say, under £30) is not necessarily a pointer to a company which will pay relatively high dividends; it simply represents the figure

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obtained by dividing the issued capital by the number of acres planted, and must be subject to many qualifications.

Small investors must bear in mind the essentially speculative element in rubber shares. The earnings of rubber companies depend upon the price of the commodity. This fluctuates widely, and, as in the case of sugar, is too often the sport of political expediency. To-day the price is conditioned by the policy of the United States, which is the largest consumer. Manufacturers there are only allowed to use a certain proportion of natural rubber in the manufacture of tyres. The balance must consist of synthetic rubber. Again, small variations in the price of rubber make a great difference in producers' profits. For instance, in 1941, the last pre-invasion year, every 1d. per lb. on the standard production of Parit-Bruas represented 9.7 per cent on the issued capital, and in the case of Sungei Buloh, 8.13 per cent. These are extreme cases. But there are very few instances in which the 1d. per lb. represents as little as 2 per cent on the issued capital.

Snags of "Low-priced" Shares

It is a notable feature of the rubber share market that it contains many shares with a low denomination, reflecting, in part, the fact that capitals in the industry are often small. These low denomination shares can be a snag for the uninitiated. They "look cheap"—given 2s. shares at par, an investment of £100 will buy the apparently impressive total of 1,000 shares. But they have their disabilities. Rubber shares tend to be a one-way market—either all buyers or all sellers. There are so many small companies that often the shares are a poor market. This means that the jobber may be justified in making a 3d. price—say, 1s. 6d. for sellers and 1s. 9d. for buyers.

That may not seem an extravagant margin; indeed, having regard to the poorness of the market, it may not be extravagant at all. But do buyers of that share realize that this 3d. jobber's turn is equivalent to a jobber's turn of 2s. 6d. on a £1 share standing at 16s. 3d. middle? Add the fact that brokerage commissions are relatively very much heavier on a low-priced share than on more "expensive" counters, and it will be appreciated that the small investor out for a quick turn often has the dice heavily loaded against him in the rubber share market. Those who rush into an obscure rubber share during a period of temporary market activity may subsequently find themselves landed with a holding sale of which involves a big sacrifice. Marketability, in fact, is of cardinal importance in rubber shares.

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By reason of the popularity of the 2s. rubber shares the yields in such issues tend to be lower than those on comparable £1 shares. High yields are, however, customary in a speculative section such as rubber, and while their exact level fluctuates heavily in accord with sentiment regarding rubber prospects, besides the fortunes of individual companies, it may be noted that many leading Malayan £1 shares which had resumed dividend payments after the war were showing yields ranging from $7\frac{1}{2}$ per cent to over 10 per cent in the spring of 1949. Ceylon shares also gave similar high yields, but most of the leading companies in Ceylon (an important exception being the giant Grand Central company) also grow substantial amounts of tea or other products. Ceylon estates were not in the immediate war zone, but the Japanese invasion of Malaya and the Netherlands East Indies meant that all-out rubber production was demanded of Ceylon, with all its consequences of heavy tapping—much heavier than would be considered good for the trees in normal circumstances. Ceylon, too, has been suffering badly from relatively high operating costs, due to local conditions. And the comparatively low yields per acre may necessitate very substantial replanting operations.

In Indonesia (broadly equivalent to the Netherlands East Indies) early promise of substantial production following the recovery of estates was far from fulfilled at first. Many major estates are on the East Coast of Sumatra, an important section of which has shown exceptionally good progress towards rehabilitation. Central Java was the stronghold of the Republicans, and for a long time little knowledge was available as to the fate of the estates in that area. At the time of writing leading Java and Sumatra companies have yet to regain the dividend-paying stage after the war-time suspension; but given reasonably settled political conditions such market leaders in the Netherlands Indies section as Allied Sumatra, Bah Lias, United Serdang and Anglo-Batth Plantations of Java will always be prominent in any period of bullish sentiment, though the very fact that the market in the leaders is comparatively broad tends towards relative over-valuation of the shares when compared with lesser-known shares which theoretically are better value for money—perhaps from both the statistical and the agricultural viewpoints. So much depends on whether the purchaser of rubber shares prefers a freely marketable issue to a lesser-known share of merit, often offering exceptional potentialities.

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Similar considerations, of course, apply to Malayan issues. Assuming that the present disorders are satisfactorily settled, periods of optimism regarding the commodity are likely to find major reflection marketwise in demand for such leaders in this section as London Asiatics, Anglo-Malays, Bikams, Labus and Cheviots. (These are merely quoted as examples of leading well-administered estates, not necessarily as recommended shares.)

Glut of Rubber ?

SEEING that Indonesian estates were only re-occupied recently the spotlight has been on Malayan shares since the war ended, but the market in them was badly affected by the outbreaks of political violence in Malaya in mid-1948, so that for a time, at any rate, Netherlands East Indies shares seemed to offer better speculative possibilities.

In June, 1947, THE INVESTORS' CHRONICLE rubber share index (Base December 31, 1923=100) stood at 58.3 and the spot rubber price was around 8d. per lb., at which only a few of the low cost producers, or those making special grades such as sole crêpe, which sometimes command a substantial premium over standard grades, could make a profit. By May, 1948, the price of rubber was over 1s. per lb., but the I.C. Index was still no better than 59, though the higher price for the commodity would mean substantial profits for the great majority of Malayan producers. By the end of July, 1948, with the outbreaks of violence gathering strength, the I.C. Index was 53.9. Spot rubber was then 1s. 2½d. Continued troubles in Malaya, coupled with doubts regarding the demand for increasing Indonesian production, had by May, 1949, brought the I.C. rubber index to 40, the lowest level recorded in recent years, with the spot rubber price back to 10½d. By the way, rubber shareholders can often get a fair idea of commodity prospects by watching the prices of rubber for future delivery. Where these are lower or higher than the spot price, the inference is obvious; the normal position is for forward prices to show a small premium to allow for the extra incidental costs of a forward purchase.

The outlook over the next few years, assuming satisfactory settlement of present political turmoil in Malaya and the Netherlands East Indies, is for substantial increase in natural rubber supplies. Java and Sumatra production will presumably revive, and output from these Dutch territories seems likely to be at least

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as important as that from Malaya. Then the effort to reduce costs by replanting old areas with high-yielding rubber strains means an eventual increase in annual yields. Outputs for many companies therefore will be considerably higher than their pre-war standard, since production will increase from, say, 400 lb. per acre from the old plantings to at least 1,000 lb. per acre for the budgrafts and similar high-yielding strains which have been used in replanting. New uses for rubber are continually being found, while the motor industry is constantly growing. So great a stake has the U.S.A. in the motor industry that U.S. demand for rubber, whether natural or synthetic, largely governs the future of the commodity. Synthetic rubber production usually employs petroleum as its raw material. From time to time we may again see periods when petroleum products are in short supply; this will handicap further synthetic rubber development, but the U.S.A. may be relied on to keep at least the nucleus of a synthetic rubber industry in being for strategic reasons, though the authorities also took a decision to build up a substantial stock of natural rubber for defence purposes. The moral of all this is clear—holders of rubber shares must do their best to follow U.S.A. rubber policy closely, for it governs the prospects of their holdings to an important extent.

All-in costs per lb. (that these are truly "all-in" must sometimes be verified by a check with the accounts); production of rubber per mature acre; the ratio of areas planted with new high-yielding budgrafts, etc., to the total planted acreage; the amount which 1d. per lb. profit on the potential crop represents as a percentage on capital; the net liquid assets per planted acre; the potentialities of other crops grown, particularly with Ceylon undertakings—these are some of the statistical and agricultural details that will commonly be found set out in or readily ascertainable from rubber companies' annual reports. They can be called in aid in assessing the merits of individual shares, but the statistical approach, though tempting when such a wealth of information is provided, and though much employed in Stock Exchange firms' reviews of rubber shares, must not be relied on too implicitly.

It is often wise to ascertain whether the company under consideration markets its rubber in one of the less common forms which may command a premium over standard grades. Sole crêpe and liquid latex may be instanced in this connection; but so far the undoubted industrial possibilities of liquid latex

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have lacked adequate recognition, and companies marketing their production in this form have been somewhat disappointed.

Yields of trees vary greatly on different soils, and the higher the yields per acre the lower the trend of the costs of production. The rubber industry to-day is passing through a transition stage, owing to the low price of the commodity, the disorders in Malaya and the Netherlands East Indies, the slow progress of European reconstruction and the tasks imposed by rehabilitation in the lately occupied countries. Heavy jungle growth has to be cleared, drains, embankments and means of transport restored, bungalows, coolie lines, factories and sheds repaired or rebuilt. Then looted or destroyed machinery and equipment must be replaced. In the case of many companies temporarily dispossessed by the war, the first call on profits when the estates were re-occupied was made by such rehabilitation expenses, and these absorbed a large part of initial profits in many cases. An important question inevitably arises in such circumstances. Are financial resources strong enough to stand the strain? If not, reconstruction or a Debenture issue may be necessary. This may make resumption of dividends on many rubber shares very remote. In any case, it can be accepted as a general principle that financing by Debentures is an undesirable thing in any volatile industry such as rubber cultivation. War damage claims are likely to be heavily scaled down, and it is doubtful whether their final outcome will be reasonably favourable.

Points Investors Should Watch

ESSENTIALS in selecting a rubber share for investment are (1) Potentialities of production, and (2) the possession of sufficient financial resources to stand the strain of a long period of low prices for the commodity. If past precedent is any guide, even when abnormal post-war circumstances have been overcome, rubber may be in the doldrums for years at a time, and during such periods adequate funds are indispensable if the company is to get quickly off the dividend mark when prosperity returns. Some plantations are steadily falling off in yields, and given low prices for the commodity are no longer economic propositions. Others with potentialities have areas coming into bearing which may eventually, when the trees are fifteen years old and given ninety trees to the acre, yield over 2,000 lb. to the acre.

To summarize all this, therefore, we may say that a good rubber share is one where:

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- (a) Capitalization per acre is moderate. (This, however, needs to be qualified by the remarks on capitalization earlier in this chapter.)
- (b) Finances are strong enough, first, to take care of the post-war emergency and, secondly, to see the company through any subsequent depression.
- (c) The price is not obviously out of line with those of other rubber shares.
- (d) There is a good market (good enough to make the shares readily realizable at any time), and one where jobbers' turn and broker's commission together are not disproportionately high.
- (e) The management is alert and forward-looking in its planting policy.

Provided the investor is satisfied that there has been no change in (b) and (e) in the meantime, a convenient and fairly reliable short cut can, of course, be found by comparing the present price of a share with the best levels it has reached in the past, and the level of past dividends.

In the right conditions the rubber share market will yield fair and possibly quick speculative profits. But it is a specialized field, into which the small investor will enter, unaided, at his peril.

So much for considerations which are mainly financial in their implications. Now let us examine some scientific and agricultural aspects of this important dollar-earning industry. Unless present indications are misleading, the rubber plantations industry may before long face disequilibrium between output (natural and synthetic) and consumption. It will be vital then for the plantation industry to reduce its costs, since synthetic competition has come to stay, in the opinion of good authorities. So it follows that the problem of the moment is the encouragement of rich yielding areas. The best tree is that which gives the best economic return. But how is this obtainable? Obviously by replacing old rubber with approved budgrafts or selected seeds of proved rich yielding capacity. Strangely enough, these methods of cultivation were at first received with prejudice by planters generally. And yet every experienced horticulturist should have anticipated the great advantages to be derived from this natural development and the growing of trees budded from record latex bearers rather than from the "hit or miss" seedlings which had been generally used previously.

The Dutch were the pioneers in the new methods, and among British estates, the Anglo-Dutch, the Prang Besar and the

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Gula-Kalumpong companies. On the "hit or miss" plantations, of which some still exist, it was difficult to find two trees alike. On one tree the cut would fill the latex cup, while on another only one-tenth of the latex cup would be filled. Observation soon proved that latex yields of trees displayed very considerable variations. Then cupping tests showed that generally 20 per cent of the trees yielded half the total crop, or four times as much as poor yielders. What then more natural than to use seeds or bud-grafts from high productivity trees in laying out new plantations? Here a few definitions may prove useful:

Latex is the viscous milky fluid obtained by tapping rubber trees, which coagulates as rubber, but which nowadays is sometimes marketed in liquid form.

A *clone* may be defined as the whole vegetative offspring derived from a single tree, called the mother tree, or as all the trees originating from the buds of a single tree.

Mother trees, then, are those from which the budgrafts originated.

Selected seed is seed collected from recorded high yielding mother trees.

Legitimate seed is seed gathered from controlled crossings between selected parents.

Illegitimate seed is seed derived from budded trees, where only the mother tree is known to be present.

Pedigree seedlings are legitimate seedlings obtained by hand pollination between specified clones. Yields from these during the first tapping years approximate to those of budded trees of the same parent clone.

In 1914 the propagation of the *Hevea brasiliensis* (the tree which is virtually the only source of cultivated rubber nowadays) by budgrafting was found possible, and experimental stations were soon started in Java and Sumatra, among which the most famous has been that of Buitenzorg, a delightful village in West Java, albeit situated in the saddle between two smoking volcanoes. As an example of the vast amount of research work being carried on in providing improved strains of rubber trees, at this station along 50,000 crossings a year were being made of the best clones before the recent war. Only about 5 per cent proved successful. Nearly all the earlier clones have been discarded. Many belied their early promise, or developed unfavourable secondary characteristics, while fresh clones were discovered of superior quality and giving higher yields.

At the outbreak of war with Japan, estate rubber in the

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Netherlands East Indies covered 1,750,000 acres. About 500,000 acres, or nearly 30 per cent, were budgrafted. In Malaya, according to recent official statistics, only 12.7 per cent was planted up with high yielding material. How much has been destroyed in the Netherlands East Indies by the war has yet to be ascertained, and it is to be hoped that some part at any rate of the valuable pre-war research work will have been preserved.

Although true high yielding trees are not necessarily good breeding parents and *vice versa*, yet the probabilities are great that with careful hand pollination of a good breeding mother tree, another mother tree possessing the same family characteristic of higher quality may be produced. However, indications point to an upper limit having been reached with annual production of 2,000 lb. per acre, although recently cases have occurred when even this figure has been exceeded.

Budgrafts are as capricious as human beings in their tastes, habits and characteristics. Some budgrafts—like T.J. 1, T.J. 16, Avros 49 and B.D. 10—have cosmopolitan tastes, caring little where they are planted. On the other hand, B.D. 5 loves the jungle swamps and the washed out tea lands of Ceylon. In the eighth year of tapping, this clone yielded nearly 32 lb. per tree. Some are good starters the first year, but yields fall off later. Glenshiel 1, on the rich alluvial flats of Carey Island, at five and a half years has given 840 lb. per acre, against 670 lb. by T.J. 1. In the second year, however, dry patches appear in the cupping cut and yield decreases. Avros 256, in which the original budgrafts gave promise of very high yields, “flopped” in 1940. Out of the many Avros clones, Avros 49 has survived the tests of time and, unlike T.J. 1 and several other high yielding clones, battles as bravely with the winds as the stout oak. How the same budgraft may vary on different soils or environment is remarkable.

Before a budgraft becomes “approved” and safe to plant on a large scale, we have to wait for the third bark renewal to see whether the promise of high yields is maintained, and to see that no unsatisfactory secondary characteristics appear. The earliest clones and still among the best developed are T.J. 1 and T.J. 16. The history of the former goes back to 1916, and where the soil is firm and no wind damage is to be feared (though this can be guarded against to a certain degree) T.J. 1 remains the prince of clones, with its ally T.J. 16. Most clones are infertile. But T.J. 1 and T.J. 16 are fertile, and whether T.J. 1 or T.J. 16 is used as the mother tree the results are equally good. Just before the war, T.J. 1 was still in fine fettle, yielding over 2,000 lb. per

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acre on the Tjirandi estate, despite the age of the trees. It was, however, deemed desirable to introduce a milder tapping system, lest brown bast might develop. (Brown bast may be described as physical degeneration following on the strain caused by too intensive tapping.)

We have only touched on one aspect of rubber selection. Much might have been said on many other themes—for example, the various tapping systems by which the bark of the tree is cut to obtain the flow of latex—but sufficient has been said to show how in the choice of rubber shares something more is required than par capitalization per planted acre, past dividends, yields per acre and the vague statements on which rubber shares are so often recommended and bought. One deduction may safely be drawn—and that is that profits from good budded areas should be three to four times as great as those from unbudded areas. Costs on them, moreover, might be so low as largely to drive synthetic rubber out of the field except where synthetic is used for a few products required for special purposes—and provided, of course, that political considerations permit economic facts to have full and natural play. But this desirable state of affairs for the plantation rubber industry can hardly be in immediate prospect, for nowadays rubber trees are seldom regarded as ripe for tapping until they are seven years old, and before the war only part of the necessary replanting had been accomplished.

As this chapter receives its final revision natural rubber's spot price is under 10½d. per lb. Few estate costs are yet low enough to render such a price attractive, so that the need for long-term measures to reduce costs, like those outlined above, becomes more vital than ever, especially in view of the manner in which synthetic rubber is entrenching its position in the all-important U.S. market.

CHAPTER VIII

TEA SHARES

A stable industry—The pre-war tea auction system—Varied grades of tea—War-time bulk buying still persists—Advantages of high-quality producers—Common tea producers' handicaps—High share yields, but restricted market—Pests and climatic vagaries—Production and consumption prospects—The tea plant's characteristics—Processing teas—Pruning and manuring practice—Awaiting the bearing period—Strong finances essential.

Why does the small investor so often invest his savings in industries of which he possesses neither knowledge nor experience? Is he not better advised to restrict his interest to industries and companies dealing in things met with in his daily routine, whose general fortunes he can follow without necessity for detailed expertise? To those who think along these lines, the appeal of tea shares should be strong, for at no point in the day is the average British investor more than an hour or two from his last or his next cup of tea. Demand for tea is not normally subject to any very marked fluctuations, and this makes for a stable industry. Yet even so THE INVESTORS' CHRONICLE tea share index (Base December 31, 1923=100) fluctuated between a highest of 92.7 in January, 1948, and a lowest of 65.5 in May, 1949.

Before the war a leading factor influencing the tea share market was the individuality of the prices secured for their tea outturns by the various companies. This was due to the system of auctioning the crops from individual estates, mainly in London, whereby full play was given to the special characteristics of flavour, etc., appertaining to an individual garden. So even one company might secure a varied range of prices per lb. for the produce of its several estates.

In considering the fortunes of the tea industry during the years since 1939 we have to remember that temporarily this individualistic system was largely obliterated by the war-time arrangement whereby Britain purchased all the tea surplus of Ceylon and India, prices being based on the 1936-38 average receipts of the growers with allowances (adjusted from time to time) for the increase in operating costs. The same bulk buying policy was continued in 1946. But for 1947 the two main

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producing countries reopened the free auction system so far as Calcutta and Colombo were concerned, though they agreed that our Ministry of Food should be allowed to ask for offers from growers at a fixed tender price. Higher free market prices naturally entailed a sharp rise in the cost to the Ministry, but growers who decided not to tender all or any part of their crops fared better than those who did, as they secured about 4d. per lb. more by selling their tea at the Calcutta and Colombo auctions. That is a position which persists to some extent at the time of publication, but it is becoming less pronounced.

When the 1948 tenders were invited by the Ministry of Food it offered another 2d. per lb. increase on the 1947 price. Ceylon got this, plus customary provision for adjustment in costs as governed by the local index of cost of living. In India labour agreements were known to involve substantial rises in operating costs, and provision to reimburse growers of these was expected to bring a large addition to the Ministry price. Arrangements for the 1949 tenders are being made on similar lines.

As this book goes through the press, therefore, the business of marketing tea is in a transition stage. It may be that individual auction prices may gradually resume in full their old-time importance, when with the auction prices published for each individual estate the grade of tea produced by a given estate was an important factor, though at the moment it is difficult to envisage London auctions resuming their predominant place. India and Ceylon have so far objected to the revival of the London auctions, and there are signs that they will make every effort to build up their local tea marketing organizations as far as possible to replace London by Calcutta and Colombo. Many measures to this end are under consideration in India (where a sharp growth in India's own consumption is a major factor), and even the infant Dominion of Pakistan aspires to the creation of a tea market in Chittagong for its own production.

It is the broad trend of the Eastern auctions which needs watching in present circumstances, and here it seems that the first post-war exuberance of prices is wearing thin. Informed opinion is that as a whole the 1947 results of tea companies probably reflected a peak year for tea-growing profits. That means that while the immediate outlook for sound Indian and Ceylon tea producers is still good, it would be wise for those contemplating tea share purchases to see that their chosen companies have a good margin of profit per lb. over their costs. This will generally entail selecting producers of high quality teas, for though all companies alike

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suffer from the continual rise in costs resulting mainly from post-war currency inflation, the companies which command a good price for high-grade teas have more margin to play with.

Contrariwise the Northern India common tea producers are finding it hard going at a time when the wages they pay have been levelled up in districts like Cachar and Sylhet, which formerly paid lower wages than other districts. This happening to coincide with the effects of unusually severe drought in these same districts, a big fall in 1947 profits and dividends was exceptionally shown by some of these undertakings at a time when for the industry as a whole results were good. The incident is also a reminder of the need for discrimination in the tea market between producers of high-grade teas and producers of lower grades. That need was emphasized by the trend of events in 1949.

Tea Share Characteristics

IN a permanent work of this character detailed reference to the merits of individual shares would be robbed by the efflux of time of any value it might possess, but it is at least permissible to recall the names of one or two particularly high-grade producers, such as Nuwara Eliya Tea in Ceylon, and Budla Beta Tea in Northern India. Typical good yields per acre are shown by these (1947) figures: Jokai (Assam) Tea, 1,184 lb.; Dima Tea, 1,380 lb. Those interested in tea shares should carefully study up-to-date financial and agricultural particulars of the companies which attract them before taking action.

An important point to remember is that most tea shares are tightly held, so that they must be regarded as high-yielding investment holdings, for there is little or no scope for short-term speculation here. In compensation, yields on the shares are usually on the generous side, having regard to the good and stable average results shown by the tea share market as a whole over a very long period of years. Octogenarian companies are fairly common in this market, and the Assam Co., the first grower of Indian tea, dates back to 1839.

As regards dividend yields, returns ruling on some leading shares in the summer of 1949 ranged from $7\frac{1}{8}$ per cent on Nuwara Eliyas to $10\frac{3}{4}$ per cent on General Ceylons, and from $9\frac{1}{2}$ per cent on Assam Frontiers to $10\frac{1}{2}$ per cent on Jokai (Assam) Teas and to $11\frac{1}{4}$ per cent on Makum (Assam) Teas. Considerable variation in the yield structure is seen from time to time. Naturally, where

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yields are exceptionally high this indicates that the outlook is regarded with caution. For example, in 1949 yields have lengthened in Ceylon shares in recognition of the difficulty which these companies are likely to experience in keeping costs down. Another drawback to Ceylon shares which may be removed if a satisfactory double taxation agreement can be negotiated is the high combined rate of United Kingdom and Ceylon taxation, equal to about 14s. in the £ in 1948.

From the purely agricultural angle, one of the important points to bear in mind is the extent to which tropical agriculture in particular is prone to attacks of disease, often implying costly remedial measures. In 1948, for example, the plant disease known as blister blight was seriously worrying Southern India tea producers, and also those in Ceylon, where this fungus, with its prejudicial effect on tea crops, was a newcomer; by 1949 it was reported to be spreading to Sumatra. The unpredictable effects of climatic vagaries must also be allowed for, as in the case of all tropical agriculture. Hail damage, whereby large quantities of tea can be lost, is not infrequent with Northern India companies; they commonly make regular provision against this contingency.

India is the No. 1 tea-producing country, and next comes Ceylon, whose growing importance in the world tea situation has been effectively demonstrated recently. The Netherlands Indies (mostly producing common teas) normally constitute another important producer, before 1941 responsible for one-fifth of world production. But the spread of the recent war to Java and Sumatra caused a serious setback to Netherlands Indies tea estates. India and Ceylon have done much to fill the gap thus created, which means that if the Netherlands East Indies regained its old volume of output world tea supplies might be excessive. But in the intervening period there may be further hopeful developments in the world demand for tea. The internal demand in India expanded greatly during the war, and the consumption per head among the large populations of India and Russia, for instance, is still far below that in the United Kingdom, Eire or Australia. World-wide propaganda for the encouragement of tea consumption is carried on through the International Tea Market Expansion Board, and such activities have been assisted since the end of the war by abolition of tea rationing in some countries, though at the time of writing individual consumers are still rationed in two of the leading consuming countries, the United Kingdom and Australia.

TEA SHARES

Political changes in India have left their mark on the tea industry. Some estates formerly in Northern India are now situated in Eastern Pakistan owing to the creation of the new Dominion, and with a new frontier to cross this means inconveniences in the matter of securing administrative decisions, selling crops and obtaining supplies. But pronouncements made during 1949 on behalf of India and Pakistan encourage the belief that British capital embarked in the tea estates and other enterprises will be well treated. A number of important Indian tea groups have either secured tea properties in East and Central Africa or are considering such a step in view of the desirability of spreading risks in these days. The African tea industry is as yet comparatively small, but it is evident that good yields can be obtained on the right type of estate. In the case of one Indian company £300,000 of new capital was raised for a venture into Kenya.

How Tea is Produced

To round off this chapter, here are some details of tea technique. The tea plant is a member of the camellia family, and in its natural state it grows into an evergreen tree forty to fifty feet high. For commercial purposes tea is grown not as a tree for wood, but as a bush and a flowering shrub. Plants are reared from seeds, from layers, from cuttings and budgrafts. Though it demands a well-drained subsoil, the plant loves hot, moist climate with abundant sun and rain, and the biggest outturns are obtained in the hot-house atmosphere of the tropical and sub-tropical plains and on the slopes of volcanoes in Java. The famous Nuwara Eliya gardens, which produce the finest quality teas, rise to a height of 6,200 feet, while in East Africa tea is grown at an altitude of 7,000 feet. The higher the ground the finer the quality generally, and the lower the yield, as in the case of the Darjeeling Co., where the yield in 1947 was only 437 lb. per acre, compared with 1,426 lb. per acre in the case of Halem, an Assam undertaking. The best grades of Indian teas come from Assam and Darjeeling. In the forcing climates of the plains in some districts of India, Ceylon and Java, the plucking stage may be reached within two and a half to three years, while full maturity may be reached a few years later. In hilly areas like Darjeeling, where seasonal changes are more marked, the growth is slower and full maturity may take ten years or longer. The minimum cost to-day of opening up the jungle and bringing a

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garden into bearing with full equipment would be £150 per acre or even more.

Tea, as sold, is made in the factory. The three chief types turned out are: (1) Black tea, the type most commonly made, whose characteristic is that the leaves are fully fermented; (2) Green tea, which is steamed to prevent fermentation; and (3) Oolong, which is semi-fermented, and so a cross between the two. Among the miscellaneous types the chief is brick tea, which is supplied in large quantities in that form by China to Russia, although China produces all types. India, Ceylon, the Dutch East Indies and East Africa turn out black tea almost entirely. Japan manufactures both black and green, and Formosa black and oolongs.

In the tea factory, black tea goes through various processes. First comes withering. The plucked leaves are thinly and evenly spread on racks of tightly drawn hessian cloth or wire mesh. These provide a free current of air and aid evaporation of the moisture until the leaves become soft as velvet and fit for rolling. In this process the leaves undergo a chemical change. The leaf cells are broken up, and as the juices become exposed to the air fermentation sets in and oxygen is absorbed.

The tea passes from the fermenting room into drying machines and is subjected to a continuous blast of hot air. This serves to stop further oxidation and evaporate the natural moisture. The juices then solidify. The leaves harden, and on leaving the driers are of the usual black colour and form. Then the dried leaves are sorted and graded by sifting machinery with meshes of different sizes into broken and leaf grades, or Pekoes. The broken grades consist of the small leaves and those resulting from cutting, while the leaf teas are made up of the lower grades remaining after sifting of the broken grades. Pekoes are classified as Orange Pekoe, Pekoe and Pekoe Souchong. Broken grades are known as Broken Orange Pekoe, Broken Pekoe and Broken Pekoe Souchong. The remaining fragments are sold as fannings and dust. The buds give the tips and the finest teas, the Orange Pekoes. Souchongs are the result of coarse plucking. Broken grades are generally superior in quality to the leaf teas, brewing a stronger tea with a darker colour.

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The tea plant has to be trained to become a bush two to four feet high, whose main function is to produce leaves. This is effected by very skilful pruning, for which practices vary greatly, even on the same estate. The objects of pruning are to keep the bushes producing leaves; to keep plucking within easy reach; and to keep the bushes healthy and free from pests, and so to encourage activity in producing "flush", that is, young leaves. In Northern India, the flushing period varies from eight to nine months. In Southern India, Ceylon and Java, flushing goes on all the year round and may continue as long as three years, this depending on the district, elevation and climate.

To maintain fertility, manuring is necessary, and nitrogen is the most important factor. Leguminous plants, which are rich in nitrogen, are freely grown among the tea bushes. These serve to provide shade, bind the soil and create humus. Potash and phosphates are also employed.

The tea industry requires large capital investment, and there is little inducement to float new companies. That is indeed a security for the position of existing estates. The cost of land, equipment and machinery is very considerable, and a large skilled labour force has to be built up. The period before tea bushes come into bearing is seven years on the average and in some cases may be eleven. And when this stage is reached, working capital has to be built up to a very considerable amount in the case of Northern Indian companies because a heavy expenditure is necessary before the crop is harvested, and for three to four months, depending on climatic conditions, no "flush" of young leaves is being produced. For six months of the year it is all outgoings at a high rate, and no incomings. Northern Indian companies require very much larger capital than Southern Indian, Ceylon, Java or Sumatra tea companies, which benefit from the "flush" continuing all the year round. For ultimate success a highly conservative financial policy is necessary. It is a good practice, in attempting to assess the relative merits of tea shares, to pay special attention to this question of finances. One usual method is to calculate the net liquid assets per planted acre (Chapter XVIII in this book discusses calculations of this type in detail), for where these are relatively high the chances

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are that the share is a sound one in its particular group. Avoid companies whose liquid resources seem poor. Many post-war factors have tended to increase the amount of working capital needed by tea companies, and any disappearance of bulk buying by the Ministry of Food would throw this matter into high relief. In mid-1949 it was being estimated that in such circumstances tea costs financing in Ceylon would call for about 2s. 6d. per lb. against 8d. before the war.

An important factor making for stability in the industry is that tea cannot be kept in storage long without losing flavour. Many Java teas lose flavour in three to four months, and Indian teas after seven to nine months. Abundant crop years thus leave no surpluses overhanging the future. And if in the next few years the revival of Java and Sumatra production brings a temporary excess of supplies to market there is a simple remedy always open to the tea industry, and one which contributes to its relative steadiness. It is to substitute fine plucking for coarse plucking—in other words, to pluck only the best leaves from the bushes and so to pay regard to the quality of the product rather than its quantity. In the conditions brought about by the war quantity had to be the first consideration. As shown earlier in this chapter, that may not always be the position.

CHAPTER IX

NEW CAPITAL ISSUES

Methods of raising capital—"New money" in a new enterprise—Selling an existing business—Prospectuses—Offers for sale—Placings—Introductions—Valuation of "rights"—Studying new issue details—Assets valuation policy—"Stags" and new issues—The reasons for underwriting.

WHEN joint stock companies were still a novelty, and before the law regulating companies had attained anything like its present elaborate structure as expressed mainly in the Companies Act, 1948, invitations to provide capital for an untried project were delightfully free and easy. Here is a quotation from a new capital issue prospectus of 1832: "By the information which has been obtained from the most authentic sources, the income likely to be received from this undertaking will be most ample to the stockholders." A skimpy eighteen-line document offered this single sentence as the sole clue to the prospects of a new company, and invited investors of the day to put up the £400,000 original capital of the very first passenger railway project inside London. This was the London and Greenwich Railway, still forming an important part of the Southern Region of British Railways.

Prospectuses were not all like this—for example, the original Great Western Railway prospectus contained quite painstaking revenue estimates. But we have progressed greatly in this particular sphere since 1832, and so the "vetting" of new capital issues is now easier, though still calling for much circumspection.

We illustrate that assertion in the course of this chapter, which explains how the new issue market works nowadays, and how investors considering new issues should set about the appraisal of securities offered to them.

A Stock Exchange has two main functions—to make a market in securities already in existence and to assist in the raising of new capital for capital-hungry institutions. Not all new financing operations are done through a Stock Exchange, of course. Development may be financed through the ploughing back of profits, through the issue of privately held mortgages, by means of bank advances, or through the good offices of institutional investors such as insurance companies and finance houses. It

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remains true, however, that much non-Stock Exchange new issue financing is done with the determination ultimately to bring the business to a Stock Exchange, and it may thus be said that one way and another the Stock Exchange machinery is indispensable to a major portion of new issue finance.

It is essential at the outset to appreciate that new issues fall into two broad classifications. The first category is the genuine new issue, the case where the raising of money will be reflected in or will assist the creation of brand new investment in factory, machinery and plant, or stock-in-trade or work-in-progress, or will repay to the bank the money the latter advanced temporarily for such purposes. Thus, if a company is formed to raise capital to start a new manufacturing project, or if an existing company decides to construct a new factory, their new issues would be real new issues. On the other hand, the second category of "new issues" does not really constitute new issue business in the economic sense of the phrase. It consists of the retailing, the re-sale to the general public, of securities already in effect in existence, where the physical investment behind the securities took place some time in the past, maybe years ago. Additionally, the second category includes operations where a "new issue" is made to convert or repay an old issue, as in the case of, for example, the conversion of a 5½ per cent Debenture stock. In the jargon of the City, the second category of issue, generally speaking, involves no "new money"; it is this fact which has made the attitude of the Government in applying control to such operations so difficult to understand.

These two broad classifications are reflected in the mode of making new issues. Where new money is involved, issues are made (1) by prospectus; (2) by offers to existing shareholders; and (3) by tender. Where no new money is involved, the methods employed are (1) offer for sale; (2) placing; and (3) introduction. On occasion, the line of demarcation between the two broad types of operations may become blurred; for example, it is possible that an institutional investor or investors will subscribe new money for a genuine new issue, and then re-offer the new issue on to the general public by means of an offer for sale or placing. But in the great majority of operations, the outline given stands.

Pros and Cons of Placings

OFFERS for sale and placings have been much in the news in recent years. Almost invariably, such operations follow the

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purchase by an intermediary (issuing house, firm of brokers, merchant bank, etc.) of shares of a previously established business. These shares, or possibly shares in a rearranged capital, are then offered to the public, the intermediary making a turn sufficient to pay his expenses and provide his profit. In offers for sale the procedure, so far as the investor is concerned, is broadly the same as in the issue by prospectus. The investor studies the advertised details of the offer, fills in his application form, sends the necessary cheque, and then hopes to secure his allotment in full or in part. With placings, the procedure is different. Details of the company and its shares are advertised, but there is no application form. Instead, the would-be purchaser of the shares instructs his broker to get his (the purchaser's) name "put down". The broker will then approach the jobbers who are to deal in the shares in an endeavour to secure an allotment for his client at the price at which the shares are being made available to the public. Generally speaking, the expenses incurred in a placing are lower than those in an offer for sale. But it has been found that it is difficult for the "under-privileged" investor to secure shares in a placing, since the professional "early birds" generally manage to secure most if not all of the shares available. Equally, of course, the man in the street may find his application for shares in a popular offer for sale heavily scaled down or even rejected altogether. But the consensus of opinion seems to be that the offer is the fairer method; in theory, at least, all applicants start level.

The "introduction" is a relatively rare event. The essence of an introduction is that: (1) There should be a large body of shareholders; (2) there should be no "deal" in the shares; and (3) there should be shares available to start the market in the initial stages. If all these three factors are present, and there is sufficient interest in the company, a market and normal dealings will spring up in the shares. An introduction does not mean any relaxation of the advertising requirements of the Stock Exchange.

With the first two types of "new money" new issues—issues by prospectus or offers to existing shareholders—readers will be familiar. Subscription to an issue by prospectus is made through completing the application form attached to or enclosed with the prospectus, and sending it, with the appropriate cheque, to the agency designated. Offers to existing shareholders—which may sometimes be coupled with offers to another class of shareholder in the same company—involve what are known as "rights". For example, if a company's shares are quoted at 40s.

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and shareholders are entitled to subscribe for one new share at 30s. for each three existing shares held, the "rights" are said to be worth 2s. 6d. This figure is arrived at as follows: The cost of the three shares which must be held to obtain the right to subscribe for the one new share at 30s. is 120s. A sum of 30s. must be laid out on the new share. Thus the total outlay for existing and new shares will be 150s. This will secure four shares, giving an average cost per share of 37s. 6d. This is deducted from the market price of the existing shares, to obtain the "rights" of 2s. 6d. The value of the "rights" will, of course, vary as the market price of the existing shares varies, but the point which inexperienced investors too often miss is that "rights" are a marketable commodity which may be sold in the Stock Exchange if the investor is unwilling or unable to take up the new shares offered to him. Too often does such an investor throw away the letter of renunciation together with the other forms and circulars, without realizing that he may be throwing away cash. If he sells the "rights" he is giving someone else the opportunity to buy the new shares at a price below the market level for the old; for doing so, he receives compensation in the market value of the "rights". (The question of the "bonus" tax payable by a company making such an issue no longer arises, as this tax was abolished in 1949. The buying of shares in this way has, since the doubling of the stamp duty in August, 1947, acquired fresh attraction, because both stamp duty and transfer fee are avoided.

Offers by tender are relatively rare, and will become even rarer with the nationalization of gas and electricity undertakings, for they are most frequently encountered in the financing of public utility companies. The borrower will advertise that it is willing to receive tenders for an issue of securities. A minimum price is usually stated, and it is, of course, a waste of time for the intending subscriber to offer less than this minimum price. Apart from this, it is up to the subscriber to make up his mind what he is willing to pay for the securities. In doing so, he will be influenced by general market conditions, the yields offering on comparable securities, and so on. The borrower will naturally accept the highest bids, and reject or scale down bids made at lower levels. The framing of a bid in an offer by tender thus calls for nice judgment; too low a bid may mean too few or no shares; too high a bid, too many. It is probably for this reason that offers by tender are so few and far between.

"Weighing up" an Issue

WITHIN certain limitations, it is of course true that the appraisal of a new issue differs in no way from the appraisal of a share which has been quoted on a Stock Exchange for many years. Those who read the chapters on analysing company accounts elsewhere in this book will, we may hope, know how to assess the merits and demerits of the balance-sheets and profit and loss records which are advertised in all cases where a company is making its bow before the British investing public. But even where the investor may be highly expert in the normal methods of security assessment he may make mistakes in appraising a new issue if he is unfamiliar with some of the particular snags which new issues involve.

He may, for example, overlook the fact that just because a company is a newcomer to the Stock Exchange, investors generally (but not invariably) require a somewhat higher yield on its shares than that obtainable on the shares of another business, comparable in nearly every other respect, but with whose shares the investing public has been familiar for generations. He may make insufficient allowance for the fact that the newcomer's capital is small, and that in consequence the market in the shares may die away to nothing once the initial interest aroused by the issue has subsided. He may overlook the fact that "atmosphere" counts for a great deal in new issue business. If the "stags" are on the feed (we shall discuss the art of "stagging" in more detail later) a dubious issue may have a resounding success. A week later, when something has happened to frighten the "stags" away, an intrinsically much sounder and more attractive offer may be a failure. Even if he is an expert at reading company accounts, the investor should appreciate that the study of long-term trends in balance-sheets is impossible where merely the latest balance-sheet is advertised; and it is very rare for more than one balance-sheet to be included in the particulars.

The investor may, of course, merely back the issuing house or other agency sponsoring the issue, just as some people back the stable without bothering unduly about the form or fitness of the racehorse. It is certainly true that the name of the issuing house counts for a good deal, and now that the days of the "mushroom" issuing house appear to be largely finished, any reputable issuing house, for the sake of its own goodwill, will do its utmost to ensure that it sponsors only those new issues which have a good chance

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of staying the course. Even so, this by itself is obviously an unsatisfactory method of appraising a new issue. It is hardly necessary to go back to earlier new issue booms to prove that even the most reputable issuing houses can and do sponsor some issues which turn out very badly for the investor. A study of the records since as recently as 1946 will show that sponsors of the highest standing can make blunders which cost the investor dearly.

Generally speaking, we would say that the investor should exercise greater care in the new issue operation where an existing holder is "getting out" than in the case of a "straight" new issue where new money is required for development or expansion of an established business. There may, of course, be good and sufficient reasons why existing holders need to sell their shares. They may be elderly folk, whose entire fortune is locked up in the business whose shares are being sold, and who will face, within the foreseeable future, heavy demands for death duties. It may be a tightly held family business which is in question, whose proprietors merely wish to establish a market in the shares, without relinquishing control, so that they can command reasonable liquidity in the event of emergency. In such cases well and good. But where the existing shareholders are selling out entirely or in large measure, the small investor can well ask himself why he is expected to buy shares when those who have been really familiar with the business for years have decided that the time is ripe for a sale. Particularly should he be on his guard when the offer is made after an inflationary period and on the strength of what may prove to be the record of a few years' exceptionally favourable trading. This is not to say that all such offers are suspect; it is merely to stress the need for careful appraisal. A plain statement as to the interest retained by the erstwhile proprietors is fortunately becoming a fairly frequent feature of new issue particulars; where this is missing the potential purchaser should be wary.

The already multifarious requirements as regards the information to be provided have been swollen by dividend limitation. So far unofficial guidance only is available as to the information desirable on this point, it being understood that the Stock Exchange Council favours the view that the directors' policy on the restraint in paying dividends suggested by the Chancellor should be indicated in the prospectus or statement for public information. And it is becoming not unusual for some such indication to be given, though in view of the one-sided

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fashion in which dividend limitation has operated it is not surprising that some directors are reluctant to commit themselves too rigidly.

The drafters of prospectuses and offers for sale, being but human, have developed the habit of well displaying the good selling points in a prospectus or offer for sale. But the would-be subscriber should be at pains to read also the paragraphs, notably what are known as the "contracts", which are printed in the smallest type the printer can command, and which are often worded in complex legal language. It is from these paragraphs that the reader will discover how much, if any, of the capital the vendors propose to retain; what the managing directors propose to take out of the business by way of remuneration, and for how long; how much various parties made out of the deal; and so on. He must digest all this information with the greatest care. Having done so, he must then decide (a) whether he wants the issue as a permanent holding; (b) whether it is worth "staggering" for a quick turn; or (c) whether it should be left to someone else—or the underwriters.

In the case of the "straight" new issue, full records going back over many years will be available to assist the investor in making his decision. The market estimation of the business will be reflected in the prices of its already existing securities. The directors of the company will say why they want the money. In such cases, it is a relatively straightforward matter for the investor to decide whether he will support the issue.

It will be noted that nothing has been said about subscribing to the new company. Advice on such projects is hardly necessary, for the simple reason that the new companies are not permitted these days to approach the Stock Exchange investor until they have ceased to be new; until they have established a profit record to prove their worth. This is not the place to argue whether this state of affairs is to the benefit of the country or not. The fact is that the Stock Exchange got itself a bad name during earlier new issue booms, because of the unfortunate experiences of untried and speculative flotations, some of which were subsequently proved to be ramps. Understandably enough, the Stock Exchange Council decided that it could not afford and would not have a repetition of such events. In the result, any new business must finance itself from non-Stock Exchange sources until such time as it has become established. It is virtually impossible for, say, a new motor car company to approach the investing public before it has produced a single car, as was the

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case in America recently. This point is worth bearing in mind when considering some of the "flotation profits" which may be disclosed when the securities of an erstwhile "new business" are marketed; such profits have to be measured against the initial risks someone took, before they can be adjudged too large.

New issue prospectuses and particulars should be closely examined on the point of assets valuation. The basis of that valuation, especially in periods when the purchasing power of money is fluctuating widely, can often have a vital bearing on the extent of the demands which future depreciation allowances make on profits. Sometimes assets of a newly formed company are the subject of a new professional valuation prepared only shortly before the issue is launched. That course nowadays means that assets are taken into the accounts at a valuation expressed in depreciated post-war pounds; such valuation might shrink in future years if the effect of currency inflation passes away. So caution should be exercised regarding the occasional new issue based on a professional valuation alone. It is better for this to be accompanied by a statement of the written-down book values previously adopted for the assets. Comparison will then show the extent to which assets have been written up.

Contrariwise, it is a point in favour of an issue if it is based on balance-sheet values of assets which have been well written down, while at the same time it can be shown that the promoters are disregarding present-day monetary appreciation of assets. An example is provided by the offer for sale made in July, 1948, by United Biscuits—an amalgamation of two long-famous biscuit manufacturers. In that case total fixed assets stood in the books at a written-down value of £1,290,619 at 31st December, 1947. But at the same date professional valuations showed those same fixed assets as worth £3,695,206 on the basis of a going concern. So here the public offer of capital was made on a very conservative basis.

Finally, mention must be made of a point which has aroused no small amount of controversy recently. Some issues have "gone wrong" although at the time the issue was made most of the then current trading year had passed, and it would seem to the average person the directors should have known that all was not well. This has led to the suggestion that if a substantial part of a company's year has elapsed at the time of an issue the company should produce a statement, preferably vouched for by the auditors, saying what the profit experience to date in the current year has been. This is a reasonable suggestion. Indeed, there is

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everything to be said for the American custom of auditors' quarterly profit statements—for all companies, not merely in the case of new issues—and very probably we shall come to this practice in the fullness of time. The ten-year profit statements which new companies have to publish are not necessarily a good guide to future results in an uncertain world.

The "Stag" and the Underwriter

No review of the new issue market would be complete without a discussion of two highly important adjuncts to that market—the "stag" and the underwriter. The "stag" is the subscriber to a new issue who subscribes not with any intention of taking up any shares allotted to him as a firm, virtually permanent investment, but in order that he may resell at a profit during initial dealings. Strong views are held on "stags". They are regarded as a nuisance, interposing themselves between the issuing house and the permanent investor, and causing a good deal of wasted time, manpower and paper; or else they are seen as an indispensable part of the new issue mechanism. The judgment, it is fair to say, depends largely on the state of the new issue market at any particular moment. If market conditions favour new issues, the "stag" piles pig on pork; he ensures that an issue which would have been oversubscribed, say, ten times, becomes fifty times oversubscribed. In such circumstances he is unpopular all round; he causes a lot of unnecessary work to the issuing house, and he defeats his and other investors' ends by causing a scaling down of allotments to ludicrous levels. But let market conditions worsen overnight, and the "stag" will be warmly welcomed.

The truth of the matter is undoubtedly that the "stag" does fulfil a useful and economic function. The fact that this function is at times distorted and abused is no reason for abolishing the "stag". In an attempt to limit abuse, the Cohen Committee on Company Law Amendment recommended and the new Companies Act enacted that applications to new issues shall be irrevocable for three days after the opening of the lists. But neither recommended the abolition of the "stag", and indeed it is difficult to see how the latter's activities can be legally proscribed.

Readers will appreciate from the foregoing that "stagging" activities, although superficially very attractive, in fact call for peculiar and rare qualities if they are to be consistently profitable. Provided an investor is willing to face the hard work involved in large-scale "stagging"—the obtaining and filling in of the

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maximum number of application forms, the writing of cheques, etc.—and is also willing to see his funds locked up in such applications, he has also to trust his judgment and flair to avoid “staggering” the wrong issue. Quite frequently he would be justified in “staggering” an issue which he would not for a moment consider holding as a permanent investment—for the simple reason that he believes the speculative atmosphere of the moment is likely to bring a sufficient oversubscription and opening premium to justify the operation; in other words, not liking the issue, he nevertheless banks on “finding a mug” to relieve him of the shares at a profit.

Given the right speculative conditions, there can be no doubt that “staggering” can be made to pay, although whether the dividends are commensurate with the labours involved is a moot point. And the small investor in particular should appreciate that should speculative conditions change sharply—as they do sometimes—the “stag” who has applied for 30,000 shares in thirty applications in the hope of getting 3,000 may find himself landed with 30,000. Moreover, almost inevitably, in such circumstances, the opening price is going to be at a discount, and for weeks afterwards the quotation will be depressed by forced sales from over-extended “stags”. Truly, “staggering” is a field for the specialist.

Many of the points discussed in question with “staggering” have relevance in connection with underwriting. An underwriter is an investor who undertakes, in return for a commission, to take up any portion of an issue not subscribed for in the normal way when the issue is made. There is a refinement of underwriting known as “firm underwriting”. This happens when the underwriter undertakes to take up part or all of his underwriting, whatever happens. Thus, an institution may agree to underwrite £30,000 of a big Debenture issue, and of that £30,000 will underwrite £10,000 “firm”. In other words, it will in any case take £10,000 of the issue; and if the issue is undersubscribed it will also take its share of the unsubscribed portion. Underwriters are often criticized for similar reasons that “stags” are criticized—that they get paid for services which they will obviously not be called upon to fulfil. Where, for example, attractive new shares

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are issued well below the market price of the old, it is often said to be unnecessary and wasteful to underwrite the issue.

Nevertheless, underwriting is a useful insurance, without which the new issue market could not function. It is so easy to be wise after the event. Between the date of the announcement of the terms and the day on which cheques must be sent to the company or its agents, so much may happen to upset earlier calculations in regard to market conditions. Moreover, it must be appreciated that underwriting is a continuing function. The institutions which in the main fulfil that function could hardly be expected to thrive on a diet of skim milk from which all the cream had been extracted. Before the war, at any rate, it is probably true to say that, on the average, underwriters were lucky to break even on underwriting account—it was so easy for the modest profit made on, say, ten successful issues, to be wiped out, or more than wiped out, on one unsuccessful transaction. It was often a safe bet, in running through an institutional list of investments, to attribute the unfortunate holdings to underwriting. (And the underwriter who is too choosy may find his services dispensed with when the plums do occur.)

The small investor is but seldom called upon to play the part of underwriter, since those responsible for the issue are naturally anxious to ensure that institutions of the maximum substance stand behind the operation. Nevertheless, offers of underwriting may sometimes come the way of the small man, if, for example, he is a client of an issuing house with a large "direct to the customer" tradition. In these cases he may be able to earn a small profit for himself. But he should realize that he is running the risk that he will be called upon to fulfil his obligations, and for this reason alone he should limit his total possible commitment to the amount of the new issue he would normally be prepared to take up; in other words, he should regard his underwriting commitment as firm.

Two final points may be mentioned. First, as a means of spreading the risk, the issuing house itself or the underwriters may pass on underwriting to sub-underwriters, paying to the latter an appropriate share of the underwriting commission. The ultimate underwriter, of course, is responsible for taking

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unsubscribed stock, to the extent of his underwriting commitment, and these days underwriters take great care to see that sub-underwriters are not "men of straw". Secondly, the phrase "underwriting and overriding commission" is sometimes seen in prospectuses. Overriding commission is drawn by those responsible as primary underwriters for seeing that the issue is fully and properly underwritten; it is, in short, the premium paid to ensure that "men of straw" do not figure in the list of ultimate underwriters. The fact that overriding commission has had to be paid can be construed as a sign of weakness in an issue—although this is not invariably true—on the argument that if the issue is really well regarded by those institutions which specialize in underwriting it will not be necessary to go beyond their circle to find underwriters.

CHAPTER X

LIFE ASSURANCE AS AN INVESTMENT

Attractive investment yields—Benefits to the sur-tax payer—The tax rebate on premiums—Examples of endowment policies—"Non-profit" and "with-profit" contracts—An investment for large capital sums—Policies for personal income—Annuities—Taxation tangles—"Annuities certain"—Combination of "annuities certain" and deferred life annuities.

To consider a life assurance policy purely as an investment without regard to the protection afforded in the event of death is entirely contrary to the earliest conceptions. It is, however, an established fact that life assurance, with its attractive investment yield and sound financial backing, competes successfully with Government, municipal and other gilt-edged stocks. This rather surprising position has been achieved by centuries of progress along conservative lines guided by statistical and actuarial research. It is in no way an exaggeration to state that what must be considered to-day as exceptionally attractive yields—the equivalent of from £7 to £10 per cent gross on a Stock Exchange investment—are obtainable under a life policy effected with a first-class assurance company. The investment element in life assurance has not been fully exploited by the life offices, who still adhere to the opinion that the primary purpose of life assurance is to provide death cover. Partly for this reason, the investment angle has hitherto been given all too little consideration by those in the higher income tax ranges. Maybe, also, the idea did not appeal to the sur-tax payer, his wealth seeming to eliminate any necessity for it. From the point of view, however, of lightening the burden of taxation, as well as conserving capital, the sur-tax payer could hardly put his income into any equally sound investment yielding so high a return. That this is becoming more and more appreciated as each successive impost on capital and income emerges is evident from the very considerable increase in the number of policies now taken out as medium or short-term investments by higher taxpayers.

All forms of investment are affected by the present very high rates of income tax, sur-tax and death duties. It would appear incredible, but it is nevertheless true, that, while a life assurance

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policy is the ideal method of meeting death duties on smaller estates, the wealthy man is unlikely to be able to afford a policy of sufficient amount to cover this liability. Indeed, such are the combined effects of heavy income tax, sur-tax and death duties, that it has become a practical proposition for a very wealthy man, in certain circumstances, to "shed" a large portion of his estate during his lifetime and, without in any way lowering his standard of living, to utilize life assurance to the greater advantage of his beneficiaries than would have been possible had he retained his entire wealth until his death.

TAX SAVINGS ON LIFE ASSURANCE PREMIUMS

Income £	Income Tax and Sur-Tax Payable (shillings and pence omitted)			Tax saved by invest- ment in life assurance £
	If there is no life assurance £	Effective rate s. d.	If 1/6th of income is in- vested in life assurance at a premium not exceeding 7% £	
1,000	234	4 8	205	29
1,250	324	5 2	288	36
1,500	414	5 6	370	44
2,000	594	5 11	536	58
2,500	869	6 11½	796	73
3,000	1,156	7 8½	1,069	87
4,000	1,781	8 11	1,664	117
5,000	2,456	9 10	2,310	146
6,000	3,181	10 7	3,006	175
7,000	3,956	11 3½	3,752	204
8,000	4,731	11 10	4,498	233
9,000	5,556	12 4	5,293	263
10,000	6,381	12 9	6,089	292
15,000	10,906	14 6½	10,468	438
20,000	15,656	15 8	15,073	583
50,000	44,906	18 0	43,448	1,458
100,000	93,656	18 9	90,739	2,917

Note.—The basis taken is the earned income of a married couple who have no young children in respect of whom abatement of income tax could be claimed. Tax rebate on premiums is made to *all* income tax payers on the basis of the *total* income, whether "earned" or "investment".

WHERE the money to be invested is from surplus income—whether earned and/or unearned—if a portion (not exceeding one-sixth) of the total income be invested annually in an assurance policy at a premium not exceeding £7 per cent of the sum assured, tax at the rate of 3s. 6d. in the £ on the amount of premiums has been (since 1916) allowed off the assured's income tax. In

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accordance with the provisions of the 1948 Finance Act, a policy holder with premiums over £25 per annum and paying tax at the full standard rate will, as from 1949-50, receive tax relief at two-fifths of the standard rate for the time being, such relief while standard rate remains at 9s., being equal to 3s. 7d. in the £. But in the table on page 144, showing the effect of the tax concession on varying incomes, tax rebate has been taken at 3s. 6d. in the £.

A further tax allowance is in effect obtained since the difference between the total cost of the assurance and the policy proceeds at maturity is not charged either to income tax or sur-tax.

The extent to which these tax concessions weigh in favour of investment in life assurance is shown in the following example of a fifteen-year "non-profit" endowment policy in respect of a person aged forty-five years at a premium rate of £6 6s. 8d per cent.

Total income	... ..	£3,000
Amount of investment (one-sixth of income)	... ..	£500 per annum
Annual premium of £500 will provide a guaranteed sum assured—(payable at end of 15 years or at previous death)—of	... ..	£7,894
Total net cost over 15 years (tax rebate deducted at 3s. 6d. in the £)	... ..	£6,187
Excess of proceeds over outlay	... ..	£1,707
or		
An average annual excess of	... ..	£114
Yield under the policy (compound interest, free of tax)	... ..	3 per cent
Equivalent gross yield (income tax and sur-tax at 11s. 6d. in the £)	... ..	7 per cent

Should it be desired at any time to discontinue payment of premiums, each premium already paid would secure its proportionate part. For instance, if the policy illustrated be discontinued after five annual payments have been made (after one-third of the policy term) the assurance would remain in force for one-third of the original sum assured, i.e., £2,631, for which premiums less tax rebate will have amounted to £2,062 and the assurance of the life, under which an immediate estate of £7,894 would have been provided in the event of death, has been thrown in for nothing. Thus in no case would the policy holder be tied to the policy in order to make it a good investment and yet the longer the annual premium is paid the better is the investment. One important advantage a life policy has over many other forms of investment is its value as a "hidden" reserve against which it is possible to borrow on demand in emergency and that without ignominy, there being no moral obligation to

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repay until the policy becomes a claim. The most uneconomic course an investor can adopt is to surrender a policy for cash, but even so it does not follow that a loss must ensue. If the policy here illustrated be surrendered at the end of ten years, the cash value would amount to £4,460, against net premiums of £4,125. On the other hand, if the policy be surrendered after only five annual payments have been made the cash value would be £1,484, as compared with a net cost of £2,062, which means in effect that the life cover of £7,894 has been obtained during the five years at a net cost of £1 9s. 5d. per cent per annum.

With or Without Profits ?

IN considering the question of a life policy, the investor is at once confronted with the necessity of choosing between a "with-profit" policy and a "without profit" policy. The fact that "with-profit" assurances are the more sought after does not mean that "without profit" assurance, which grants a larger guaranteed sum assured for the same cost, is out of date and unworthy of consideration. The term "without profit" has not an agreeable sound and is apt to be taken literally, but the illustration already given will have proved it a misnomer. In the course of their long history British life offices have built up an enviable reputation for integrity and conservative finance, and there can be no question that in ordinary circumstances the policy with participation in profits is the more attractive investment. The following illustration will serve to show the remarkable investment yield under a "with-profit" policy in respect of a person aged forty-five years at a premium rate of £6 18s. 10d. per cent. The profits are declared annually and have been conservatively estimated:—

Total income	... ..	£3,000
Amount of investment (one-sixth of income)	... ..	£500 per annum
Annual premium of £500 will provide a 15-year endowment assurance with participation in profits for a sum assured of		
Estimated proceeds at maturity (sum assured and profits)	... ..	£7,202
Total net cost over 15 years (tax rebate deducted at 3s. 6d. in the £)	... ..	£8,800
Excess of proceeds over outlay	... ..	£6,187
or		
An average annual excess of	... ..	£2,613
Yield under the policy (compound interest, free of tax)	... ..	£174
Equivalent gross yield (income tax and sur-tax at 11s. 6d. in the £)		4½ per cent
		10 per cent

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Should the investment be discontinued, each contribution paid would secure its proportionate part—as under the “without profit” example—with the advantage that under the “with-profit” policy all profits accrued to date of discontinuance are added in full to the paid-up policy, and, further, the profits declared by the company year by year will continue to be allotted to the paid-up policy on the basis of the reduced sum assured, notwithstanding the fact that no further premiums are payable. For the purpose of true comparison between “non-profit” and “with-profit” contracts, our illustrations have been prepared on the same basis with respect to the age of investor and the term of investment, but for younger or older ages, as well as for shorter or longer term contracts, the investment yield is equally attractive.

Attention has so far been focused on the investment of surplus income. What of the investor who has, say, £5,000 to £10,000, or more, which he desires to lock securely away for ten or fifteen years at a rate of interest above that obtainable in the gilt-edged market? The competitive nature of life assurance as an investment medium for large capital sums received official recognition during the war years, when single premium payments were limited to £1,000 as a means of eliminating rivalry with Government stock issues. This limitation is still in general application by the companies at the time of writing. In mid-1948 an assurance company announced its preparedness to accept on its annuity fund a capital sum which, after payment of tax (and sur-tax, if any) on the interest allowed by the company on the sum deposited, would be sufficient to provide the annual premiums under an endowment assurance. Whilst these facilities have by general agreement among the assurance companies since been withdrawn, there would appear no reason why an investor should not obtain the same result by spreading his investment over two separate companies. In effect the investor would purchase what is known as an “annuity certain”—under which payments are guaranteed for a stated term of years, then cease—and apply the income from this annuity to annual premium payments under an endowment assurance with another office. The companies would, of course, need to be carefully selected if the most advantageous results are to be obtained. It will be appreciated that the limitation of £1,000 in respect of single premium payments for whole-life or endowment assurances is at present being rigidly enforced by the companies in general.

An investor who is willing to spread his capital investment

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over three years might with advantage overcome the single premium limitation by applying one-third of the capital sum each year to an annual premium payment under a ten or fifteen year with-profit endowment assurance, and, at the end of the third year convert the assurance into a paid-up policy. The following will serve to illustrate the results obtained by this procedure in respect of an investor aged forty-five next birthday, investing a capital sum of £10,000. The figures shown are close approximations. An annual premium of £3,333 would provide an endowment assurance with participation in profits for a sum assured of around £45,600 payable at the end of fifteen years or at previous death. Upon the policy being discontinued at the end of the third year of the assurance (after one-fifth of the policy term) the assurance would remain in force under a paid-up policy for one-fifth of the original sum assured, i.e., £9,120, to which all profits accrued to date calculated on the original sum assured would be added in full. On a conservative estimate the bonus additions should bring the value of the paid-up policy—sum assured and bonuses—to around £11,200. The profits declared year by year will then continue to be allotted to the paid-up policy on the basis of the reduced sum assured, notwithstanding that no more premiums are payable. The actual cost of this investment would be reduced by tax abatement on the three annual premiums, subject to the statutory limitations. At maturity the contract should yield around £13,400, while, in addition, the investor will have had life assurance protection to the extent of over £45,000 during the first three years of the investment. Particular care should be taken to select an assurance office with a favourable bonus earning record, and also to ascertain that it is the company's practice to allot bonuses to paid-up policies.

Whilst this review has dealt with the merits of life assurance as an investment medium for surplus income, and as a safe repository for capital, the needs of life assurance generally fall into two categories—namely, protection and saving. Within these two main classes are a host of exigencies for which life assurance caters. If used in connection with business and financial transactions, such as in the case of partnership agreements, reversionary interests, settlements under marriage contracts, etc., the assurance contract will necessarily vary in its nature with the circumstances of the individual transaction. Where, however, the need is of a domestic kind, e.g., for family protection in the event of premature death or for provision for personal

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retirement, it will often be found of advantage to ignore "capital" as such, and to provide "income". In this respect assurance has shown itself particularly enterprising and adaptable, and most offices are able to offer attractive "tax free" income schemes with economically based premium rates. A man's earning power is a wasting and destructible asset. It is in helping to preserve that earning capacity against the time when it would normally decline or cease that lies the logic of life assurance.

Annuities to Increase Income

COMBINED with other invested funds, an annuity will be found to be a useful means of increasing the average interest income.

Although an annuity is one of the simplest forms of contract to effect, extreme care is necessary in its selection if the maximum benefit is to be gained from the investment. It is, however, no exaggeration to say there is an annuity plan to suit every financial circumstance.

The usual objection to annuities, of course, is that they involve the taxation of capital returned and spent as income. This is an objection which increases in weight with every rise in taxation. Annuities have never proved a simple taxation subject. It is held, on general lines, that an annuity represents a return of capital and interest, and that only the interest should be taxed. On the other hand, it is the not altogether convincing official view that an annuity represents capital converted into income, which therefore should be taxed. As the result of a legal decision some years ago, a taxation exception was made of annuities certain, payments under which do not depend upon the life of the annuitant but are made in any event for a definite number of years. By this decision, when the income yielded by an annuity certain is divided actuarially into return of capital and interest and certified accordingly, income tax is calculated on the interest portion only of each payment under the annuity. Thus we have two forms of annuity, the payments under both consisting partly of returned capital and partly of interest, treated quite differently for taxation purposes.

The purchase, by a lump sum payment, of an immediate annuity providing an income for life is the oldest and best known form of annuity contract, but owing to the unfavourable taxation basis applying to this type of annuity it is fast yielding pride of place to the "annuity certain" and to a combination of two contracts, i.e., an annuity certain and a deferred annuity.

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The ordinary immediate annuity, however, is by no means entirely out-dated and unworthy of consideration. To those who have no interest in preserving part of their capital in the event of early death, and to whom ways and means are a vital necessity, an immediate annuity offers an income for life impossible to obtain by any other method. It is eminently suitable when the circumstances of the annuitant are such that he is not liable to income tax, or subject to tax only at the lower rates. It is usual for the assurance company to pay the annuity without deduction of tax, or subject to deduction at a reduced rate, provided that the annuitant can make a declaration that his total income does not exceed certain specified limits. Since the reduction in the rate of investment income became a matter of serious concern for small capitalists the life offices have been compelled to modify their annuity rates, but are still offering attractive terms, as will be seen from the following summary of some of the more competitive immediate life annuity rates at present obtainable. The figures quoted are the annual amounts payable by half-yearly instalments without proportion to the date of death, on each £100 of the purchase money:—

Age attained		Males						Females									
		£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.				
40	...	From	5	0	0	to	5	7	8	From	4	14	4	to	4	19	0
45	...		5	10	10		5	18	8		5	3	0		5	10	0
50	...		6	6	0		6	10	6		5	11	8		5	18	4
55	...		7	1	0		7	6	10		6	3	0		6	10	0
60	...		8	1	4		8	8	6		6	19	4		7	6	4
65	...		9	10	4		10	0	10		8	2	4		8	9	8
70	...		11	12	0		12	6	5		9	16	4		10	6	5
75	...		14	13	8		15	14	5		12	8	0		13	2	10
80	...		18	18	0		20	11	2		15	15	10		17	9	8

It is an interesting problem to find the amount of life annuity required, and the quantity of capital used in its purchase, to increase one's income by a desired amount. A man aged sixty with an income of £700 per annum derived from £20,000 invested at an aggregate yield of $3\frac{1}{2}$ per cent and wishing to bring his income up to £1,000 per annum by means of an annuity, would need to convert £6,228 of his capital into an annuity for life of £518 per annum. After purchase of the annuity his income would be: (1) Annuity of £518 per annum costing £6,228, and (2) an income of £482 per annum, being $3\frac{1}{2}$ per cent on balance of capital of £13,772.

If the incidence of income tax and sur-tax could be ignored the above rates might be regarded as attractive, but as the

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whole of these annuity payments are subject to income tax at the rate applicable to the circumstances of the annuitant, an annuity certain, or a combination of an annuity certain and a deferred life annuity, is often the more attractive proposition.

An annuity certain can normally be effected for terms of from five to twenty-five years. Payments under this form of annuity are made for the full term of years selected, whether or not the annuitant survives that period, so that all the capital invested and interest must be returned to the annuitant, or to his dependents or estate in the event of early death. The assurance company would deduct income tax from the annuity payments, the tax so deducted being calculated on the interest portion only of each annuity payment at the standard rate of tax, or such lower rate as may be applicable to the annuitant. Any liability of the annuitant to sur-tax would be ignored by the company in calculating the tax deduction. It is also deserving of note that only the interest portion of the annuity payments in the fiscal year is shown as "taxed at source" income in the annuitant's return of total income for tax assessment purposes. The following brief examples will serve to illustrate the cost and benefits under an annuity certain contract. An investment of £4,963 would secure an income of £550 per annum, payable half-yearly, for ten years certain, then ceasing. A total of £5,500 must, therefore, be returned under this annuity. Assuming income tax liability at 9s. in the £ throughout the ten years, the average net income, after payment of tax, would be £526 per annum. If the term of the annuity be extended to fifteen years certain, an investment of £5,114 would secure an income of £400 per annum, payable half-yearly, for the full selected term, the total payments under the contract thus amounting to £6,000. The average net income after payment of tax at the present standard rate of 9s. in the £ would be £374 per annum.

Whilst the annuity certain is an excellent means by which to use capital to augment income during a fixed term of years, it may not by itself be sufficient to provide an income during the whole of the life of the annuitant. For this reason it is rather the combined annuity certain and deferred life annuity which has been the subject of investment demand. The transaction is arranged by the issue of two contracts, the most favourable terms sometimes being obtained by spreading the investment over two assurance companies. For the purpose of illustration:—a male life age sixty-five could effect an annuity certain of

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£300 per annum, payable half-yearly, and guaranteed for fifteen years, at a cost of £3,836, and a deferred annuity of the same amount, to commence at the expiry of the annuity certain contract, at a cost of £474. By this means an income of £300 per annum for the whole of life is obtained at a cost of £4,310, while at least £4,500 must be returned to the annuitant or to his estate. During the guaranteed period under the annuity certain, income tax would be payable on the interest content only of each annuity payment, but under the deferred contract income tax would be payable on the whole of the annuity payments.

The "5 per cent or 6 per cent Annuity with Capital Return" is a comparatively new plan and quite a popular innovation. At any age, and whether in respect of a male or female life, an investment of £2,000 under the 5 per cent scheme secures an annuity of £100 with a return at death of a substantial proportion of the invested capital. The guaranteed sum returned at death increases with the age of the annuitant at entry into the scheme.

Guidance is frequently sought by married couples with little or no capital, and living on the husband's pension which will cease on his death. At the moment the couple get along quite well, but the outlook for the wife would not be promising should the husband die and the pension cease. Such a situation is not easily dealt with, as any provision for the wife must necessarily be made out of what is invariably a meagre income. One method of making provision is by means of a reversionary annuity. This is a contract which, in return for an annual premium, provides an annuity to the wife commencing on the death of the husband. Should the wife die first, however, no return of any sort is made. Another method would be for the husband to effect a whole life assurance, with instructions to the executors to use the proceeds to purchase an annuity for the widow. Subject to the usual conditions, income tax rebate is available in connection with the whole life assurance, but not for premiums payable for a reversionary annuity.

In conclusion, the purchase of some form of annuity for life is the only way in which a person can use his capital to increase his income, without the possibility of finding himself at an advanced age with his resources on the point of exhaustion, either by his having spent his capital for current expenses or by unfortunate investments. An annuitant parts with his capital, but obtains an income which is not only certain to be paid regularly

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however long he may live, but is higher, frequently very much higher, than could be obtained otherwise with any degree of safety.

In regard to the whole field covered by this chapter, it is advisable to point out, first, that tax reliefs may be affected by any future changes in the standard rate of income tax; and, second, that the terms which life assurance companies can offer for their various forms of contract are subject to variation (sometimes fairly frequent) in accord with the interest return obtainable from time to time upon the whole corpus of their invested funds. At insurance companies' annual meetings held during 1949 the difficulty of investing new funds on terms as remunerative as those secured for investments already made was frequently mentioned.

CHAPTER XI

METHODS OF COLLECTIVE INVESTMENT

Diversification of risk—Investment trusts—Historical background—Managing the investments—Trusts' capital gearing—Market in trust stocks limited—Fixed trusts—Unit trusts—Early troubles of unit trust movement—Reforms—The role of the managers—The market in sub-units—Fixed and flexible categories of trusts—Building societies—Prodigious growth—Borrowing short and lending long—Mortgage advance policy—Investment in the societies—The income tax position.

Now we embark on a review of what may conveniently be called "co-operative investment media". Nearly all modern investment is a vast essay in co-operation, with thousands of investors, big and small, uniting through their savings to finance what seem to them to be worthwhile and profitable ventures (either actually or potentially). But, in the context in which we are using the phrase, it means the co-operation of investors among themselves, by a pooling of their funds, to secure that diversification of risk—by types of holdings (gilt-edged, foreign bonds, Debentures, Preference and Ordinary, etc.), by type of industry, and by geographical spread—which relatively few can, by themselves, obtain.

There can be little doubt that diversification of risk, in the three methods mentioned, is a thoroughly sensible proceeding. There can be few investors who cannot recall some tragedy which has arisen solely through the placing of all one's investment eggs in the one basket. And those rare instances in which an investment trust itself has departed from the diversification principle, and has specialized in stocks in one or two industries only, have on occasion provided depressing results which help to point the moral.

It is, of course, possible to go to the other extreme and to attempt to run a panel of investments so widely spread that no one person, or for that matter group of persons, can in fact supervise them efficiently. It can be proved statistically, for example, that a holding of half a dozen leading British industrial equities follows almost exactly the same course, over a long period of years, as an index containing many times that number of shares. Certain it is that an investor with, say, £10,000 or

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upwards should, if he is expert, or if he can secure expert guidance, obtain all the benefits of diversification by running a well-balanced portfolio, without incurring the expense of paying others to do the job for him and without running the risk that the experts may, in practice, prove to be not so expert after all.

It is, indeed, for the small investor that co-operative investment should be most beneficial; for the man who, having bought his house, purchased adequate insurance, and invested his quota in the Government small savings facilities available to him, yet has a few hundred pounds available which he would like to put to useful employment. He can, of course, secure expert investment supervision through the purchase of insurance shares, a sphere where vast sums of money are spread throughout every imaginable sphere of investment. But this chapter is concerned with *purely* co-operative media—investment trusts, unit trusts, and building societies.

The first investment trust was the Foreign and Colonial, founded in 1868. Oddly enough, and Irish though it may sound, the first investment trusts were really unit trusts. Thus, the Scottish American Trust (First Issue) was intended to have a life of ten years, after which its holdings were to be liquidated and the proceeds divided *pro rata* among the holders of unredeemed certificates. After these early trusts had been in existence for some time a decision of the Courts found most of them to be illegal organizations. A subsequent decision reversed this, but in the meantime the unit trusts had taken the form of limited liability companies.

These early trusts were formed at a favourable if exciting time. It was favourable because many very profitable avenues for investment were opening up, particularly in the capital-hungry new world across the Atlantic and in Australasia. It was exciting, because then, as now, crises were frequent and recurring—and there were no closed economies in those days. The crises took their toll of the trusts which had got over-extended, and kept some of them out of the dividend list for long years at a stretch. Others, however, managed to keep their heads above water and to remunerate their stockholders. Gradually, the movement became well established and secured a hold upon the affection and esteem of investors which it is fair to say it has, to a large extent, retained to this day.

But the really active days of investment trust formation have gone. At this juncture it can be said that the movement arrived in three bounds—in the 'eighties (the three years 1888-1890 saw

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no fewer than thirty new trusts floated); in the first decade of the twentieth century (between 1905 and 1914 thirty-two new trusts were born); and in the post-war boom of 1924-1929, when eighty-two trusts were set up.

There have, of course, been many English investment trusts. But many people regard Scotland as the real home of the movement, a view which represents an unconscious tribute to the skill of the pundits of Edinburgh, Dundee, Aberdeen and Glasgow rather than an exact knowledge of the history of the movement, seeing that the first trust to be formed was English and that some two-thirds of the movement's invested funds are under English control. It is, however, true that many of the finest trusts in the movement are managed north of the Tweed.

To-day, referring only to the trusts quoted on the London Stock Exchange, we find that these institutions had quoted capitals worth £421,627,938 at April, 1948. Since the stocks of most investment trusts these days are quoted below their break-up values, the real worth of the movement to-day is certainly greater than this amount. To-day, the investment trusts, although fettered as to new capital issues by our system of controls, do what they can in the country's new financing by utilizing their undistributed profits and through their interest in the Finance Corporation for Industry, the organization set up under the Bank of England's auspices early in 1945. Their holdings of dollar securities proved invaluable to us in two major wars. Their co-operation is an essential feature in many an underwriting and capital reorganization scheme; in cases where a number of trusts are concerned, the movement's "trade association", the Association of Investment Trusts, often does very useful work.

Judging Investment Trusts

WE now turn to consider investment trust companies' stocks as holdings for the small investor. This is a matter which has been the cause of considerable controversy and, at times, some heat. For the truth is that the movement can be likened to Longfellow's little girl with the curl: when it is good it is very, very good, and when it is bad it is horrid.

The yardstick which the objective observer applies is a simple one; the trust director will say it is over-simple. The observer's attitude may be summarized thus: "I know I am personally quite incapable of investing my money as it should be invested.

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My timing is deplorable; I always buy at the top and sell at the bottom. I pick the wrong industries, except when I choose the wrong companies in the right industries. Foreign Governments play me for a sucker. But here is a board of experts, willing to take my money and to earn their fees by investing it soundly and profitably. Let them take it—but I shall expect them to do better than I would if I left it in gilt-edged, or in a handful of leading industrials.”

That, it may be contended, is a reasonable enough attitude for an investor to take when employing experts to do the job for him. With many investment trusts his belief in the experts has been justified. The cynics may say that given the industrial revolution, inflation, and the law of compound interest, no trust could have avoided doing very well for its stockholders over the last fifty years. The short answer to that is that even given these conditions some investment trusts have records which are as poor as those of the good trusts are good. So the first lesson our would-be holder of investment trust stocks must learn is the need to discriminate.

At the same time he should, in fairness, appreciate that there are many snags in the running of an investment trust, even given good management. Particularly have these snags been in evidence over the last twenty years—say from 1928 to 1948. For the main snag the investor himself is, unwittingly, very largely to blame. This snag is simply that it is virtually impossible—although it *has* been done—to float an investment trust at the right time. For the right time to start an investment trust is at the bottom of a slump—when, however, few investors can be persuaded to put up the money. A trust started at or near the peak of a boom is a trust virtually foredoomed to heavy capital losses and poor dividends; if its directors can achieve capital appreciation in years other than subsequent boom years they are supermen.

Another point which investors in investment trusts should not overlook is that a trust is a *continuing investor*. It is a pleasant and easy pastime to calculate the profits which can be made by selling equities at the top and buying them at the bottom; the private individual may even carry the theory of cyclical investment into successful practice. But if the investment trust board attempts to go liquid when it thinks prices are too high, it is immediately up against the problem of finding the wherewithal to remunerate the trust's Debenture holders and shareholders. The most the directors can do, sensing trouble ahead, is to take limited steps towards liquidity; for the rest, a trust must ride

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slumps and booms like a dinghy on the high seas. It is obvious that the trust which follows a conservative dividend policy is better able to afford liquidity and avoid depreciation on its investments than a trust which distributes its income up to the hilt.

The resort of the movement to capital gearing introduced a complication. The initiators of investment trusts and those responsible for their direction during the earlier, dynamic years of the movement were quick to appreciate the fact that if investments could be made at, say, 6 or 8 per cent, and if part of the cost could be financed by fixed interest bearing securities carrying only, say, a 4 per cent rate, the balance would accrue to the benefit of the equity. But in the movement's later years the fact that its capitalization was highly geared has on occasion operated to the detriment of investment trust equities.

In this period, large blocks of foreign investments ceased to yield any return. The rate of interest was falling, and the redeemable fixed interest investments held by the trusts were being paid off or converted on to a low interest basis. Often the trust's own prior charges, bearing high interest rates, were irredeemable, or redeemable only many years ahead. It can, of course, be argued that the experts running the trusts should have foreseen and forestalled all these developments; certainly it was unwise of trusts, when raising capital on prior charges, not to keep an early or medium-term option to redeem these, if their interest burden was high. Whatever views one may hold on such matters, the fact remains that in the period under discussion capital gearing often operated *against* the interests of trust equity stocks, instead of in their favour, as had been intended. That is not to argue against gearing in all circumstances. It is to argue for flexibility in gearing by the retention of the right to repay prior charges.

A post-war problem should be mentioned here. Nationalization of many companies at home happened to coincide more or less with the need for Britain, in the circumstances prevailing after the war, to realize the greater part of her investments in South American railways and other public utilities. These two developments have considerably narrowed the field of investment open to the trusts—and not to them alone, of course, for such institutional investors as insurance companies find their reinvestment problems just as acute.

One way in which investment trusts have tried to cope with this situation, which presses with particular severity on those

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institutions with relatively high interest to meet on prior charges of their own, entails an increase in the proportion of their investment portfolio represented by industrial ordinary shares. That sometimes means taking extra risks, but the best investment trusts are sure to be very cautious in entertaining the high yields offered by some of the new industrial flotations of the post-war period. Where these are based largely on boom profits, the risks will be obvious.

There may be a case here and there where a trust has an undue proportion of post-war issues. Where this is disclosed the investor should heed the red light. In rather the same fashion it is rather difficult for the outsider to assess the merits of that minority of trusts which may disclose the possession of a relatively substantial holding of securities not quoted for the time being.

The newcomer to investment trust stocks should appreciate two further characteristics of the movement. First, there is inevitably a considerable time-lag between changes in trend in industrial profits and dividends (if it is industrial securities in which the trust is primarily interested) and the corresponding changes in a trust's own profits and dividend. This time-lag may mislead the unwary, both ways. If the market senses that industrial profits and dividends may be about to fall, it may be that investment trust stocks will be lowered in price so that on the *current*, or even the *next* dividend, they will give very "good" yields. The odds are, however, that these yields cannot be relied upon. Conversely, of course, when a rise in industrial dividends is in prospect, would-be buyers of investment trust stocks should not be deterred because the yields the stocks offer look low; that is a matter which will be put right in due course.

Secondly, the investor should appreciate that the market in investment trust stocks is a narrow and difficult one. (Generally speaking, most investors seem to hold such stocks as permanent income-producing investments, a fact which in itself does not make for rapid turnover in the stocks.) Because of the slowness of turnover, jobbers' margins tend to be wide, and often, too, investment trust equities are "heavy"—£100 of stock may be quoted at 400 or 500. (Sometimes it is possible in such cases to deal in £1 units.)

There can, however, be no doubt that the fundamental principle of investment trusts is a sensible one, particularly for the investor of small or average means, and for the investor who places stability of income above chances of capital appreciation. Investment trust stocks, in recent years at least, have not shown

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the "swings" in market value demonstrated by many industrial equities. But, given good management, their holders should, over the long term, secure the benefits of equity investment. To-day, moreover, in contrast to the position which obtained in some of the earlier days of the movement, it is quite often possible to buy investment trust equities well below the break-up values of the investments which underlie the trust equities.

As some guide to investors we would suggest that investment trusts be examined with the following points in mind:

(1) Yield offered. If higher than the average, an explanation is usually to be found in inferior past performance.

(2) Appreciation or depreciation on investment portfolio. There was no great merit in showing an appreciation, say, at the end of 1946. There was very great merit if the capital was kept intact at the end of 1940. Indeed, the trust which could show an appreciation in its holdings by 1942 or 1943 was doing very well.

(3) Dividend record. If a trust falls into arrears with its Preference dividend, that is obviously no tribute to management. The *trend* of dividends is also important. No investor will grumble if a trust starts modestly. He will give full marks to the trust which, starting modestly, can gradually step up its dividends during good times, and hold them steady during depression years. And, as we have seen, a trust which follows a conservative dividend policy can afford to take in sail during market booms.

(4) Gearing. If stability of income is required, avoid those trusts with highly geared capital, particularly if their record leaves anything to be desired.

How Unit Trusts Began

As noted earlier in this chapter, the original investment trusts in reality commenced life as unit trusts, but as the result of a legal decision they changed over to the form which has persisted ever since. For the subsequent fifty or sixty years the unit trust idea appears to have been completely dormant. And when it was revived it was the investment trust which was largely responsible. Was there ever a queerer sequence of events?

The modern unit trust really had its genesis in the United States. And it was born because of the abuses to which the investment trust movement in that country was subject during the great boom which burst, with such cataclysmic consequences,

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in 1929. When that boom burst, the investment trusts were among the hardest hit of American investors. And those who had supported them suffered a great disillusionment as the full extent of the losses, and some of the practices, of the movement were revealed. The idea of "managed investment", of entrusting money to so-called "experts" who invested it in "paper empires" and wild-cat projects without the investment trust stockholder knowing what was being done with it, received a resounding setback.

Thus it was that the ground had been well tilled to receive the "new" investment medium—the "fixed trust", as it was known in those days. To the disillusioned investment trust stockholder, the seller of fixed trust units said: "Your money will be invested in the following list of 'blue chips' (high-grade investment equities). No other securities whatsoever will be bought. Save in exceptional and stated circumstances, the holdings will never be changed during the life of the trust. The securities will not be held by the managers, but by trustees. This is foolproof investment."

It is hardly surprising, given this background, that the fixed trust (to-day known in America as the "open-end trust") fired the imagination of the American investor. It so happened that in the movement's pioneering days in that country a London stockbroker was visiting New York. He was struck immediately with the idea of introducing fixed trusts to his native land. Conversations, negotiations, argument followed. And in 1931 the first British fixed trust (appropriately enough just those four words, with capital letters, were the first venture's title) was launched. For a time it languished, and it appeared that British conservatism was more than a match for the pioneers' faith. Subsequently, however, and "all of a sudden"—largely as the result of the conversion of 5 per cent War Loan in 1932—the movement caught on. In the next seven years, fixed and unit trusts came tumbling forth in a spate. There were questions in Parliament; the Stock Exchange and the financial Press were often sceptical if not hostile; there was a Stock Exchange enquiry into the movement, and a Board of Trade Departmental Committee. Meanwhile, the great British public had entrusted some £100 millions to the new medium. Investment students may not, for one reason or another, like unit trusts. But they certainly cannot ignore them.

From the outset the movement has shown great adaptability. The idea of almost complete fixity, inherited from America, was

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soon modified. The earliest American trusts sometimes operated under rules which laid down that no security was to be sold until it had fallen from the dividend list. We have seen the reason and justification for so hamstringing the managers. But obviously such a provision is against common sense; it often amounted to shutting the stable door after the horse has bolted. Again, could any man be so far-seeing as to say that the blue chips of 1931 would be the blue chips of 1951? Because of these and similar arguments the movement gradually moved away from fixity towards flexibility. In place of the rigid list of perhaps twenty stocks we got the "permitted panel" of perhaps one hundred stocks. The movement remained faithful to the principle of telling the investor, within broad limits, where his money would go. But the managers took discretion to pick and choose within the broad panel.

The trend towards flexibility was, without doubt, sensible. But also without doubt, the trend was at times overdone. It resulted in some trusts holding relatively large blocks in obscure industrial companies whose shares were the narrowest of markets—an undesirable state of affairs. It put a premium on "management" which has sometimes not been justified; it is a melancholy fact that where fixed trusts have been converted into flexible trusts or investment trust companies, and where the unconverted fixed trust units have run side by side with the flexible trust units or the investment trust shares the price performance of the fixed trust units has sometimes bettered that of the converted media. Here, as with the investment trust movement, the crucial factor is management.

Other early tendencies of the movement included the "specialized trust", a trend which has not always had the happiest results. A great deal obviously depends on the sphere selected for specialization. "Spread" within one sphere is often insufficient, as has also been proved by the experience of some of the specialized investment trust companies already noted above.

But the unit trust movement ran into other troubles in those early days, troubles which were unnecessary. And those troubles, without any doubt, account for the prejudice against unit trusts which still exists in some quarters to-day. Since legislation and, to some extent, internal and self-imposed discipline, have now prevented a recurrence of most if not all of these troubles, there is no point in cataloguing them in detail here. In general they arose from the fiercely competitive atmosphere of the unit trust world of the middle 'thirties.

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The competition sometimes forced the disclosed management remuneration down to uneconomic levels, with the result that the temptation to supplement this disclosed remuneration by undisclosed profits was too strong to be resisted. The competition caused the advertisement of yields on units which were sometimes so high that they could only be obtained by the process of distributing capital as income. Sometimes the process should have been obvious to unit holders, but the latter failed to appreciate, for example, that the dividends of short-life gold mines contain a large element of capital, and that the sale of scrip bonuses and the distribution of the proceeds is pure dissipation of substance. This was unfortunate, for sooner or later, if one lives on capital, the fact becomes reflected in the value of the residue, and many unit trust holders were disappointed to discover, when security values in general reached and surpassed, towards the end of the war, their 1936 highs, that the value of their units, bought in 1936, had fallen.

To-day, however, the small investor may be satisfied that the unit trust movement is a well-conducted and suitable medium for the spreading of risk. (It should also be made plain that by no means all unit trust managements succumbed to the temptations presenting themselves in the pre-war years.) But now the movement finds its scope sadly circumscribed by the policy of the Treasury. No unit trust can now issue more than £50,000 of new units in any one year. (The managers can, however, reissue "second-hand" units, i.e., units repurchased from old holders.) This ban, which is in line with the ban on new money issues generally, severely restricts the scope of the movement and makes it difficult for the managers to do much more than make ends meet. It is for this reason, presumably, that the trend in the unit trust world in recent years has been towards contraction. But if the demand for the units which are available is any criterion, the unit trust movement would take on a new lease of life were the ban to be removed.

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How Unit Trusts Operate

THE unit trust is a collection of securities in which the unit holders, the beneficiaries, have an interest in the proportion that the number of units they own bears to the total number of units of which the fund is composed. The fund is inaugurated, managed and administered by a limited company—the management company (generally one management company runs a group of

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unit trusts, which are in other respects quite separate and distinct funds, in order that overheads may be spread). The management company buys and sells the securities of which the fund is composed; under the supervision of the trustee it sees that all dividends and interest are collected and that distributions on the units are duly paid; and it makes any changes in the investment portfolio (within the limits imposed by the trust deed, which latter governs all the operations of the trust) which it deems appropriate. But the management company is never (except in the sense discussed later) in physical possession of the trust's investments. These are held by the trustees, generally a leading bank or insurance company.

The managers are nevertheless the inspiration of the fund and the foundation stone on which it is built. They derive their remuneration mainly from (1) the issue of units, (2) making a market in existing units, (3) annual fees.

Revenue from (1), which is virtually non-existent to-day because of the Treasury ban on new units above the £50,000 per annum limit, arises mainly from the service or loading charge made by the managers when new units are created, plus any net revenue which arises when the price of the units is "rounded off"—from, say, 19s. 11d. each to 20s. The service charge may be made only once; it may be, say, $7\frac{1}{2}$ per cent on the price of a unit selling at 20s. (1s. 6d.). Or it may be that the initial service charge will be much smaller than this, and that a small, fractional charge will be made half-yearly during the life of the trust, in addition. This second practice, of course, explains the income arising from (3). It is important, if the service charge is levied in one sum, that the proceeds shall not be spent before the end of the life of the trust (trusts have a definite legal life of, say, ten, fifteen or twenty-one years, after which the trusts must liquidate and distribute the proceeds of liquidation to unit holders, unless the latter agree to extend the life). To secure this, a portion of the initial service charge is generally paid into what is known as an escrow fund, which is then held by the trustees, who release it to the managers, proportionately, each half-year.

Revenue from (2) arises because the managers act as jobbers in the units of their own trusts, in return for fulfilling which function they are entitled to make their turn. Thus, if a holder wishes to dispose of his units he contacts the managers, who offer him the "bid price" for his units. This bid price is generally to be found in the Press. (*THE INVESTORS' CHRONICLE* quotes a list of unit trust prices each week, including the yields where practic-

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able.) It is based upon—but may be higher than—the liquidating value of the underlying securities comprising the trust, rounded off to the nearest convenient figure—say, $1\frac{1}{2}$ d. or 3d., minus the expenses of the Stock Exchange transactions. (In some circumstances a unit holder can ask for the securities representing his units to be transferred physically to him, against the cancellation of his units.) Having bid the holder, say, 20s. for his units, and the holder having accepted, the manager then has the option either of “breaking down” the units (liquidating the underlying securities) or of keeping the units, hoping to resell them to the new holder at, say, 21s.

Some members of the public consider the spread between the bid and offered prices of unit trust units to be too large. At the two extremes, these prices represent the rounded-off liquidating price and the rounded-off equivalent of the cost of the underlying securities. Even at these extremes it will be appreciated that the extent of the spread as compared with a jobber's turn in the Stock Exchange reflects dealing expenses and, in some cases, Government stamp duty which, of course, have to be added to or subtracted from the Stock Exchange jobbers' offered and bid prices if a fair comparison is to be made. In fact, however, it is often the case that the “turn” in unit trust prices is narrower than that represented by the extremes. Both bid and offered prices are now governed by Board of Trade regulation.

In May, 1948, after two years' consideration, the Stock Exchange Council framed an amendment to its rules to permit dealings in unit trusts, jobbers being allowed to deal in the sub-units, but the initial reaction among unit trust managers did not seem favourable. Under the amendment, which imposes strict requirements, it is open to managers to apply for a Stock Exchange quotation, but many managers evidently supported the view that the public interest would be better served under the old system whereby the trust managers deal in their units as buyers and sellers. Where trust managers fall in line it will still be possible to buy the units either through a broker or through the unit trust managers. The cost is unlikely to be affected materially by the mode of purchase.

In contrast with the position in the middle 'thirties, to-day management companies must issue accounts, and it is evident from these that, on the present volume of business at least, the movement is economically run and that management profits are very modest.

The trustees play no part in the actual management of unit

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trusts. In the early days of the movement some criticism centred round the trustees. Their names, of considerable weight, were prominently advertised, and it was held that the uninitiated investor got the impression that a leading bank or insurance company guaranteed the soundness of the trust. This, of course, was not so and could not be so. Indeed, the aloofness of some of the trustees towards their trusts attracted adverse comment, particularly if some aspect of the management of the trust came under fire. To-day, as a result of the Prevention of Fraud (Investments) Act, the trustees carry more responsibility—certain unit trust advertisements must be “vetted” by the trustees before they are published. Yield calculations of unit trusts are now governed by Board of Trade regulations. These are elaborate, and among other things are designed to ensure that the cost of the periodical service charge shall be allowed for in calculating the yield, and that the value of new issue “rights” and other exotic items shall not be allowed to boost up yields artificially.

Unit trusts are divided into two main types, the fixed and the flexible, and they may be either “cash” or “appropriation” funds. Certain technical differences between fixed and flexible trusts deserve mention. When a fixed trust is started, the managers buy the securities underlying one unit—say, £100 worth of each of twenty “blue chip” equities. This unit is then divided into sub-units, which are sold. When all the sub-units of the first unit have been sold, the process of purchasing another “units-worth” of the same permitted securities is repeated. Thus, the constitution of the fund is constant.

With a flexible trust, the position is rather different. While the unit-holder in a flexible trust knows the securities in which the managers are permitted to invest, it is usually only at the time of each distribution of income that he knows exactly which securities in the panel have been bought, and in what proportions they are held. In fact, the composition of the fund of a flexible trust is constantly changing as new units are added. If the market in one stock should dry up, the managers are not forced to try to go on buying it.

With regard to the other main subdivision of unit trusts—between “cash” and “appropriation” trusts—the difference can briefly be stated as follows: In a “cash” fund, securities are only bought in the market at the moment the managers need them as the result of selling new units. With an “appropriation” fund, the managers act as principals in purchasing the securities, and they are subsequently “appropriated” to the trust at the Stock

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Exchange price level ruling at the time of the appropriation. There is the further point that in "cash" trusts the rounding-off profits already referred to can be made to accrue to the trust fund.

Just as some investment trusts have records which do them great credit, so have some flexible unit trusts. If management is poor, however, the "fixed" unit trust should do better than the investment trust, although obviously if management is poor it would be better that there should be no trust at all. Unit trusts can claim certain advantages inherent in their constitution; for example, the holder can always rely, in the event of a sale of his units, on receiving at least the liquidating value of the underlying securities, which is more than the investment trust equity investor can count upon, in view of the discount below break-up value at which these issues often change hands. On the other hand, the investment trust has the advantage that it can plough back part of its earnings into the trust and thus stabilize its dividends in bad times. This the unit trust, in the great majority of cases, does not set out to do.

Building Societies

So far, this chapter has dealt with two co-operative investment media—investment trust companies and unit trusts—which offer the investor a participation in a portfolio of, almost exclusively, Stock Exchange securities. We now come to a consideration of the third means of investing co-operatively, the building societies, which differ fundamentally from investment trust companies and unit trusts, but which nevertheless attract a large volume of support from the investing public, particularly amongst smaller investors and those who, from conservatism or other causes, tend to avoid Stock Exchange investment.

Building societies have long been an established feature of British social life, particularly among those of small means, to assist whom towards the goal of home ownership the movement was first launched. But the first building societies, which came into existence somewhere about 1780, were very different organizations from those which we know to-day. The early societies were known as "terminating societies". They were organized by a small group of workers or neighbours, who conceived the idea of pooling their resources, by initial deposits and investment by instalments, so that a start could be made on the task of providing each member of the group with his own

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house. Lots were drawn to decide the order in which members of the group should get their houses. Those who got their houses first did not come into possession as owners until all were served; they paid rent to the group until that time had arrived. When the objects of the society had been achieved, when all members had got their houses, the society "terminated".

It was just about one hundred years ago that some students of the movement appreciated that if the scope of the building societies' operations were broadened so that subject to the rules *anyone* could invest money in it and *anyone* could obtain advances from it, there was nothing to be said against, and a good deal to be said for, the permanent, continuing society, the scope of whose operations would be limited only by the demand for the mortgage advances, the ability to finance them, and the society's ambitions. Thus it was that several of the societies best known to-day came into existence in the late 1840's.

The movement's prodigious growth has been particularly marked in the last twenty-five years or so, thanks almost entirely to the great building boom of the nineteen thirties. Thus, as recently as 1926 the movement's assets totalled £193.9 millions; at the end of 1948 they had reached the truly impressive total of £1,037.9 millions. The growth, however, has been curiously uneven. The movement to-day boasts its giants. But it also includes a great number of small societies, which serve to recall the days when a handful of members met every week or every month, at the local "pub" or church hall, to hand in their subscriptions and decide on mortgage advances. At the end of 1948, according to the Registrar of Friendly Societies, 2,111,769 shareholders had invested £768,011,000 in 847 societies, giving an average shareholding of £364, while 703,431 depositors had invested £192,041,000, giving an average deposit of £273. The societies' funds had been lent on mortgage to 1,380,745 borrowers for an aggregate of £836,882,000, representing an average mortgage advance of £606.

These figures can be analysed in a different way to bring out the point already made as to the unevenness of the movement's growth. The 847 building societies have an average share capital of £906,743, and an average deposit capital of £226,731. But about 100 societies have total assets in excess of the combined average share and deposit capitals, i.e., £1,133,474, so that the great bulk of the movement, by numbers, consists of comparatively small societies. The average capitalization shown above is made higher than it would otherwise be by the out-

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standing size of the largest societies. The Halifax leads with a share capital of £96.1 millions, Abbey National runs second with £67.4 millions, Woolwich has £40.2 millions, and the Co-operative, the Leeds Permanent and the Provincial come next with £35.5 millions, £33.7 millions and £25.6 millions respectively. The capitalization figures of the major societies here quoted are revised to the end of 1948 in most cases.

There is, from time to time, discussion as to the most economic size for a building society. If the cost of running the society be taken as a yardstick, it will be found that the curve of management expenses related to total mortgage assets is at its highest with the largest and the smallest societies, and at its lowest with the societies of medium size. That small societies may become uneconomic will surprise few people. That large societies should be relatively expensive to run seems odd until it is remembered that too much "rationalization" tends to defeat its own ends; instead of a number of small societies, each maintaining their own organization in a provincial town, "rationalization" tends to bring to the same town an equivalent number of branch offices of the large societies, plus a centralized organization to look after the branches. Size does, of course, permit the spreading of risks; too much dependence on local industry, for example, can be dangerous. But there seems no reason why medium-sized societies should not secure such diversification; most of them, in fact, do so.

The *modus operandi* of building societies is simple. The societies borrow money from individuals with cash to spare and lend to approved borrowers. The difference in the rates of interest payable by the society to its shareholders and depositors and those payable to it by borrowers on mortgage advances provides the cost of management, taxation and sums set aside as reserves for the future. A perennial criticism of the movement is that it borrows short—repayment of shares and deposits can normally be demanded on very short notice—and lends long, for mortgage advances are made firm, for lengthy periods of years. Thus, to meet any contingencies which normal mortgage repayments and interest cannot cope with, the societies also hold substantial gilt-edged and other trustee investments.

Mortgage advance policy is the crux of building society finance. Before the war, the movement attracted adverse criticism because its advances policy was at times over-generous; that is to say, there was insufficient cover for the advance in the event of a depreciation in the value of the property mortgaged, either

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through jerry-building or other factors. "Pool" business, under which the borrower obtained virtually a 100 per cent advance (the excess advance over and above the normal 70-80 per cent advance being covered by cash deposits and guarantees by the builder) in particular led to abuses. To-day there is an obvious danger that the societies may be led both by their desire to do business and by the inflation of house property values to be too generous in their advances policy. But the movement is well aware of this danger, and the great majority of societies are being particularly circumspect in granting mortgages on values that are more than usually inflated by to-day's housing shortage.

Pros and Cons of Building Societies

INVESTORS in building societies, even in the soundest societies, should realize that their investment has its limitations. Except in the most limited degree—the degree within which interest rates on shares and deposits may vary in accordance with general financial and economic conditions—they are purely "money stocks"; and, as investors in the movement in recent years know full well, they lack the advantages of long-dated or irredeemable fixed interest securities in that the rate of interest can be scaled down on short notice, while in a cheap money era holders get no direct benefit from the rise in capital values which such an era causes. Building society shares and deposits thus afford no hedge against inflation, such as a direct equity in property would furnish. And the terms on which they are issued can be turned against the holder with the greatest ease. Nevertheless, they have considerable attraction for the small and more conservative investor. They provide an investment secured on an enormous spread of property; and inflation, if it brings no tangible benefit, at least increases the value of the security on which the investment is charged. If there is no capital appreciation, equally there is no depreciation. The investment is cheap to make and easy to realize. And the rate of interest is favourable.

Building society deposits rank before shares in the event of a capital repayment; and their total is limited by the Building Societies Act of 1874 to two-thirds of the amount secured by the society's mortgages. Because of these stipulations, deposits receive a lower rate of interest than shares—usually $\frac{1}{2}$ per cent less. Present rates of interest paid by building societies average 2 per cent on shares and $1\frac{1}{2}$ per cent on deposits. London and

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southern counties societies, however, pay rates roughly $\frac{1}{4}$ per cent higher. These rates are declared clear of tax, and the non-surtax paying investor is under no obligation to pay tax on the interest. (With surtax payers, the income is treated as having suffered income tax, but surtax is payable on the amount received, which is treated as the gross amount for this purpose.) Because of this, the tax paid rates above mentioned are worth 3.6 per cent gross on shares and 2.7 per cent gross on deposits—in each case to the holder liable to income tax at 9s. in the £.

The societies, of course, do not escape income tax. They pay what is known as the "composite rate", a rate below the standard U.K. rate which is established by periodical surveys of the average tax status of their members. For 1947-48 the composite rate was agreed at 4s. 6d. in the £. Whether the arrangement will be changed when it again comes up for review in 1951 remains to be seen—the present scheme avoids a multiplicity of claims for refund of tax by the small man—but clearly building society investors cannot ignore the possibility of less generous gross rates (to the standard rate income taxpayer) in future.

The present gross returns are, however, obviously attractive, having regard to the fact that holders of both shares and deposits can normally demand repayment on quite short notice. The actual period of notice varies, but is laid down in a society's rules. At times, however, building society investments can be illiquid. In times of great stress—such as the Munich crisis and at the outbreak of war—the societies naturally require the full period of notice for repayment, and early in the war they were actually empowered, by Government regulation, to demand up to six months' notice from both shareholders and depositors. Such a development, however, is rare, and it is only fair to point out that at such times other investments may also be frozen (as were gilt-edged, on their minimum prices, during the early months of the war).

Before the war, private enterprise built 300,000 houses in a boom year, the great majority of which were built for sale and probably two-thirds of which were sold with the aid of building society mortgages. In 1947 private enterprise was allowed to build a mere 32,000 houses. In 1948 the number built dwindled to just over 22,000, and the number under construction at the end of 1948 to less than 15,000. This great change has forced building societies to rely for their current business almost entirely on second-hand houses, and although their *financial* turnover

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to-day is a record, that reflects the inflation in house property values and not an expansion in the rate of *physical* turnover. The rate of mortgage repayments has been very high since the war, reflecting the general state of liquidity of the nation, and although the movement is doing good business in mortgage advances now, a slackening in demand, coupled with obstacles to new building, would cause the movement embarrassment of riches and make it even less anxious to take investors' money.

The great change which has come over the movement's financial position as a result of war and post-war circumstances—during the war years repayments on mortgage were far in excess of new mortgage advances—can be illustrated by comparing the movement's balance-sheet at the end of 1938 with that at the end of 1948.

1938							
Liabilities				Assets			
	£ mn.	%			£ mn.	%	
Shares	548.3	72.2		Balances due on			
Deposits	155.7	20.5		mortgage ...	686.8	90.5	
Other Liabilities ...	13.3	1.8		Investments ...	53.2	7.0	
Balance of Profit & Loss & Reserves	41.6	5.5		Other assets ...	18.9	2.5	
	758.9	100.0			758.9	100.0	
1948							
	£ mn.	%			£ mn.	%	
Shares	768.0	74.0		Balances due on			
Deposits	192.0	18.5		mortgage ...	836.9	80.8	
Other Liabilities ...	15.3	1.5		Investments ...	162.0	15.5	
Balance of Profit & Loss & Reserves	62.6	6.0		Other assets ...	39.0	3.7	
	1,037.9	100.0			1,037.9	100.0	

In the 1938 figures the balance-sheets of 971 societies then on the register are aggregated in the table. Partly owing to amalgamations within the movement the 1948 composite balance-sheet relates to a smaller number of societies—847.

The marked expansion in holdings of gilt-edged securities, both absolutely and percentagewise, will be noted. If the movement's "liquidity ratio" before the war was too low, in view of the political uncertainties of the time (as events proved it was), it can certainly be argued that in the early post-war years it was too high, also having regard to political circumstances. But the ratio of investments to total assets is at any rate beginning to recede, and that of mortgages to recover, so that the composite balance-sheet should gradually become better proportioned.

Subject to the limitations mentioned already, the building

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societies offer useful investment media to investors. One word of earning may be given. We normally recommend investors to confine their attentions to the larger societies. This is not, of course, to be read as reflecting upon all the smaller societies, the great majority of which are perfectly sound, even if their interests do tend to be concentrated in one neighbourhood. But we have found a snag in recommending the smaller societies. Their last accounts may show a good financial position, but it has been known for control of such societies to change into less conservative hands subsequent to the date of the last accounts, a fact of which the adviser is usually ignorant; with so many societies, it is virtually impossible to keep abreast of all such developments in the movement. Generally speaking, too, investors should be very wary of the society which advertises an interest rate which is substantially above the average for the movement. Sound building societies have sufficient difficulty in investing their funds to-day to provide the average rates mentioned in this chapter; rates well above these should as a rule be regarded as a possible danger signal rather than an attraction.

CHAPTER XII

REAL PROPERTY INVESTMENTS

Technical terms in the property business—Freeholds and leaseholds—Subletting—Property and planning—Purchase procedure—How property values are fixed—Rentals and building costs—The “years’ purchase” factor—Various types of rents—Shop and office property—Flats and dwelling houses—Factories—Agricultural land—Building land.

THIS chapter is designed to set out the fundamental principles underlying the selection of investments in real property. Strictly the term “real property” should be confined to freehold interests in land. It has, however, proved a convenient term for distinguishing between investments in land and buildings, whether freehold or leasehold, and other forms of investment, and so it is used in this book.

To-day the word “freehold” used by itself is usually intended to mean the “freehold estate”, or what the lawyer might call an “estate in fee simple”, and the owner of such an estate is as near being an absolute owner as is practicable in a populous community. Nominally, however, the King is lord paramount of all the land in this country, for in theory the feudal system introduced by William the Conqueror still survives, and it is for this reason that the owner of an estate in fee simple or the “freeholder” is still known to the law as a “tenant in fee simple”.

In addition to the freehold estate there are two freehold “equitable interests”, the tenancy in fee tail and the tenancy for life, but these are rarely met in the ordinary investment market.

The person holding a freehold or leasehold estate is the owner of that interest. A freehold owner has the broad right to use his property as he pleases, provided he does no injury to his neighbour, but in an organized community he is restricted in many ways by legislation passed in the public interest. He may also be restricted by covenants imposed on the land by private agreement, whilst the land may have the benefit of rights of light or way, or other easements over adjoining land, or be subject to such rights for the benefit of the adjoining land. If the land has the benefit of an easement it is known as the

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“dominant tenement”, and if it bears the burden it is the “servient tenement”.

The rights of a leasehold owner are generally circumscribed by the terms of the lease, imposing as a rule some degree of obligation to keep the property in repair, and restrictions against making alterations or additions to the property without the consent of the landlord and using the premises for other than specified purposes. The way in which a property is used is generally referred to as the “user”.

It is unwise to think that land and buildings can be bought or managed competently on the strength of a little reading. Experience is as vital as book knowledge, and it is cheaper to take the advice of an expert. This is not said with any idea of discouraging the owner’s interest in his property, for an owner ought to be interested; if he is not, he will be a bad owner and a bad landlord. He should have a broad understanding of the responsibilities and liabilities of ownership, for so far as his property is concerned he is the board of directors. “Urban Estate Management”, by W. A. Leach, F.R.I.C.S. (publishers, The Estates Gazette Ltd.), will give an insight into many of the matters relating to town property. For the country owner “Rural Estate Management”, by R. C. Walmsley, F.R.I.C.S., F.L.A.S. (from the same publishers) will be found invaluable.

A tenancy from year to year (or yearly), or quarterly, or other period is known as a periodic tenancy. Subject to any agreement to the contrary in the contract of tenancy a yearly tenancy can be determined by a half-year’s notice given to expire on the anniversary of the commencement of the term; a quarterly tenancy requires one quarter’s notice expiring at the end of any one of the quarterly periods, and a weekly tenancy a week’s notice expiring at the end of any tenancy week.

Leases for terms of years, especially of shops, are commonly of a type known in the market as seven/fourteen/twenty-one years, i.e., the term is for twenty-one years but the tenant has the option to determine the lease by giving notice at the end of the seventh or fourteenth years. In market parlance the tenant has “breaks” at the seventh and fourteenth years.

A reference which will be frequently met in the property investment market is “full repairing lease”. This means a lease under which the tenant is liable for all repairs. Similarly “a full repairing and insuring lease” is one imposing on the tenant liability for all repairs and insurance against fire.

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An "inclusive rent" means that the landlord pays the occupier's rates, and an "exclusive rent" that the tenant pays them. A "net rent" in auction particulars usually means no more than "exclusive rent" or "inclusive rent less rates".

Rent Definitions

THERE are many sorts of rent payable in respect of property. First, if A lets a piece of land to B, and B is to build on the land, the rent payable by B to A is a ground rent. Supposing B now lets at a higher rent to C and passes on the liability to build, the rent payable by C to B will be an improved ground rent or leasehold ground rent. Again, A may agree to let a plot of land to B at £120 per annum on which the latter is to build twenty houses, the ground rent to be allocated at £8 per house as they are completed. B will sell the houses as completed and A will grant leases at £8 per annum per house to persons nominated by B. When fifteen houses have been built B may have the last five leases granted to his nominees at a peppercorn rent (i.e., a rent of one peppercorn per annum which is not intended to be collected) and then secure a higher price when selling the houses, or he may have the five leases granted to himself at peppercorn rents and sell the houses subject to ground rents of £8 per annum, thus securing these amounts to himself as leasehold ground rents.

Where a developed property is let the rent reserved by the lease or agreement is normally a "rack rent", i.e., a rent approximating to the full rental value of the property as developed. The term "rack" as used here has no implication of the rent being extortionate! Thus A may let a shop to B at £80 per annum, and a few years later B may sublet to C at £100 per annum. Both are rack rents, although B secures a "profit rent" of £20 per annum. B is, in fact, paying a low rack rent and C perhaps a full rack rent. Alternatively, B's lease may be described as the "head lease" and the rent he pays as the "head rent". If the letting is by a freeholder the rent is a freehold rack rent, and if by a leaseholder a leasehold rack rent.

Chief rents, quit rents, fee farm rents and rent charges are in strict law different types of rent; but in market language the terms are often treated as interchangeable. They are all rents payable out of land to a person with no estate in the land. There is usually a right to recover the rent by distress, but no reversion of the land to the recipient of the rent. Usually these rents are payable in perpetuity, but they may be made chargeable on a

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leasehold interest. They arise usually when land is broken up for building purposes, the custom in some parts of the country (notably Lancashire) being to sell the freehold subject to a fee farm rent (called locally a chief rent) and an obligation to build, instead of letting on building lease at a ground rent as in many other parts of the country.

In dealing with property investments the reader may meet the terms "corporeal hereditament" and "incorporeal hereditament". The first means, broadly speaking, an estate or interest in land in possession, whilst the latter is a right over land in the possession of another, e.g., an easement such as a right of way. In this connection "possession" means the right to the enjoyment and occupation of the land or of the rents and profits thereof; hence the importance of the term "vacant possession" when a house is for sale, for an owner may be in possession through his tenant.

A freeholder may not wish to occupy his property himself, and may, therefore, decide to let it, i.e., he will grant to some other person the exclusive right to occupy and use the property either for a specified period of time (e.g., for seven years), or for a recurring period until one party gives the other notice to quit (e.g., a tenancy from week to week or year to year). By this action the freeholder has created a leasehold estate; he is now a landlord and the person to whom he has let the property is his tenant. In other words the freeholder has granted a lease or a tenancy and created the relationship of landlord and tenant. Briefly, the landlord has the right at the end of the lease to retake possession of the property demised (i.e., let or leased) together with any buildings, or improvements thereon and additions thereto, falling within the meaning of "landlord's fixtures". The property is then said to "revert" to the landlord, and the right to possession at the end of the lease is his "reversion" or "reversionary interest".

The landlord has also certain rights to forfeit the lease if the rent is not paid, or for breaches of other provisions of the lease. He has also the right in the event of non-payment of rent to go upon the property and sell the tenant's goods, but all these rights are subject to many statutory controls to prevent high-handed action.

If a tenancy is granted for a term of more than three years the contract is required by the law to be under seal, and in practice the term "lease" is reserved for tenancies created by such documents. Similarly, tenants holding under such documents are usually referred to as "lessees", the term "tenant" being reserved

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for those holding for terms of three years or less, whilst the documents under which the latter hold are more commonly referred to as "tenancy agreements".

A lessee or tenant, unless restricted by his lease or tenancy agreement, may in turn grant a tenancy to some other person. In doing so he must reserve to himself a "reversion" even if only for one day, which means that if his own tenancy from the freeholder would expire on, say, 25th December, 1950, the sub-tenancy must expire on 24th December, 1950, or earlier. The freeholder in such a case is also the "superior landlord" and the lessee is also the "mesne landlord" or "head lessee". If the sub-letting is by deed it is more often referred to as an "under-lease", the sub-tenant being known as an "under-lessee".

The original landlord and original tenant are bound to each other by what is known as "privity of contract". Thus, if L lets to T, and T assigns his interest to U, T remains liable to L because he signed the contract with him. But U and L are interested in the same land, and there is between them what is known as "privity of estate", whereby L can sue and be sued by U for breaches of covenants in the lease occurring whilst U holds the leasehold interest. Readers who wish to study further the "Law of Landlord and Tenant" will find a book under that title by B. W. Adkin and D. M. Lawrance very clear and useful (publishers, The Estates Gazette Ltd.).

"Land" is a term needing explanation. In law it includes the surface of the land, the subsoil to the centre of the earth, and the space over to the sky. The aeroplane overhead would be trespassing but for legislation dealing with air navigation!

A hole in the ground or a lake is land, and any building erected on the land becomes but part of the land. So, if a man takes a lease of a building, or even the top floor of a building, he has a leasehold estate in land, and if that top floor is destroyed he is still the tenant of the space it occupied and liable to go on paying the rent (apart from the special rules relating to war damage).

Snags for the Amateur

MANY people have become investors in real property by buying the houses in which they live; some have bought further houses purely as investments. In the main they may not have fared badly, but they have dealt with the simplest type of property, whilst their solicitors and, in most cases, the building society surveyors, have afforded them considerable protection. The

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pitfalls become, however, more numerous as land legislation progresses.

First, a property is for sale and the investor goes to see it. Can he judge whether it is structurally sound; whether there is dry rot anywhere, and whether the drains, water, electricity and other installations are satisfactory? An experienced surveyor cannot tell all this at a glance, but he can judge whether to recommend a test of the installations or the lifting of floorboards where dry rot is suspected.

Would the ordinary investor know whether a building complied with the building by-laws or possessed the means of escape in case of fire required by the London Building Acts in respect of many buildings? Again, many buildings are altered, structurally, or their mode of use altered, without the relevant building and town planning requirements being satisfied. Town planning in the light of the Town and Country Planning Act, 1947, which came into force on 1st July, 1948, is a big problem in itself. Any substantial increase in the size of a building, or a change in the use of land or buildings may attract a "development charge", and it is better to assume, until the contrary is known, that nothing may be done without planning permission.

Was the existing building erected or existing mode of use established in conformity with planning control? That means: Was the building erected or the use established in accordance with an operative scheme, or, where the land was subject at the material time to interim development control, under interim development consent? Is the property likely to be compulsorily acquired under town planning or other powers, and if so, what compensation is likely to be payable? Under some sections of the Housing Act, 1936, some of the provisions of which are applied to purchases under other Acts, the compensation may be very small.

Then there are problems under the Rent Restriction Acts, and the possibility of notices requiring the execution of works which may be served under a number of Acts affecting houses, shops and factories. Again, a shop may be bought in the expectation that the purchaser will be able at a later date to get possession and let at a greatly increased rent, and the purchaser may then find himself faced with a notice requiring a new lease or compensation for goodwill under the Landlord and Tenant Act, 1927, or compensation for improvements carried out under that Act.

Having bought a property (it is assumed that the solicitor has cleared up all questions of land tax, tithe rentcharge redemption annuities, chief rents and the like) the new owner's relations with

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his tenants depend (if not on the Rent Restriction Acts) on the leases or tenancy agreements, in which many traditional phrases are incorporated because their precise meaning has been clarified by decisions of the Courts.

How many owners know that if a tenancy falls within the Rent Restriction Acts and is weekly, a rent book must be provided; that wherever a rent book is given to a statutory or protected tenant (whether the tenancy is weekly or longer) the correct standard rent and other prescribed information must be inserted; and that in the case of dwellings suitable for occupation by the working classes the name and address of the person responsible for repairs and of the local medical officer of health must be entered, whilst the number of persons entitled to occupy the house must also be inserted in the form prescribed under the Housing Act, 1936?

The reader may think all this presents a very discouraging picture of property investment, but it is better that the difficulties should be realized from the outset. It is not just a question of reading a prospectus or a report and looking at market prices, although mistakes can be made in doing that, and the ability to read is not the only qualification for judging an investment. Real property is a matter in which practically every case has its own special considerations; it must be bought right, and it must be managed right. A valuer who holds the diploma of the Royal Institution of Chartered Surveyors has taken a stiff examination in many subjects.

The wise man only buys after receiving a surveyor's report, and does not make an offer until he has seen his solicitor, who will probably draft a letter offering a certain sum *subject to contract*. Without these words the offer, if accepted, will create what is known as an "open contract", and although the law gives the purchaser thereunder a considerable measure of protection, it is preferable that the purchaser should proceed on a contract approved by his solicitor.

The process of purchase is more expensive than with stocks and shares. First comes the preparation of contract by the vendor's solicitor and its approval with or without modifications by the purchaser's solicitor. The contract usually fixes a date for completion, and up to that date the income from, and liabilities arising in connection with, the property belong to the vendor; after the completion date they pass to the purchaser, but if completion is deferred the purchaser pays interest on the purchase money at an agreed rate.

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Next follows an investigation of the vendor's title by the purchaser's solicitor, the course of this being that the vendor's solicitor provides an "abstract of title" (really a summary of the various title deeds affecting the property), and after consideration of the abstract the purchaser's solicitor will make his "requisitions" (requests for further information in respect of the property or the title). The purchaser's solicitor will rarely trouble his client as to the technical aspects of title pure and simple, but will probably refer to him on many practical points in connection with restrictions, town planning requirements, etc., which may lead to the projected purchase falling through or the price being modified. If this position arises, it is as well for the matters at issue to be referred to the surveyor who reported to the purchaser before the offer was made.

When the purchaser's solicitor is satisfied, the property, if freehold, is conveyed to the purchaser, and if leasehold, is assigned to him. The landlord's consent is sometimes necessary before a lease can be assigned, and it is usual that the purchaser's name shall be registered with the landlord's solicitor; but the solicitor will attend to this.

In some districts, notably London and Middlesex, registration of title of freeholds or leaseholds having an unexpired term of more than forty years is compulsory, but elsewhere registration is optional. Where the title to land is registered, it is entered in the records of the Land Registry, and thereafter much of the laborious business of investigating the title on sale is avoided, sale being effected by a registered transfer. It will still be necessary, however, for the purchaser's solicitor to make inquiries as to any charges on the land under the Public Health Acts, particulars of planning and other consents granted, etc.

It follows that solicitors' costs for the purchase of an interest in land are relatively high, although not quite so high in the case of a registered transfer. There are also heavy stamp duties and the surveyor's fees, and property is therefore to be bought more as a permanent holding than a speculation. The higher costs can, of course, be taken into consideration in fixing the price to be offered, and should be regarded as a part of the capital outlay. The purchase of property also takes longer than the purchase of stocks and shares—another reason why real estate cannot be regarded as a medium for buying and selling for quick profit.

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How Rents are Influenced

IGNORING for the moment residential property, it is clear that the rental value of a property (whether land alone or land and buildings) is what the average tenant can afford to pay for its occupation, and that generally depends on the profit to be earned there. Thus, if the value of money in terms of commodities falls, and, in consequence, prices and profits rise, it may be expected that rents will rise also; if business is good and profits booming, rents will share, but if trade is bad and profits low, rents will slump. As, however, rent is rarely fixed solely with regard to short-term prospects and is so often related to long-term leases, and as, also, valuers must rely to a great extent on past experience in estimating rental values, there is inevitably a time lag between the movement of profits and the modification of rental values; it is only in the long boom or depression that they move very far from the centre of the swing of the trade pendulum, and only to such degree as inflation seems to be fairly established that they follow monetary trends.

This inherent stability, combined with the essentiality of land to the conduct of any business, renders "bricks and mortar" a particularly suitable form of investment for institutions requiring long-term investments.

The general availability of land for any purpose depends on its suitability and on transport facilities. We have also to consider a commodity of fixed quantity, for, save as fresh areas are opened up by improved transport, and to a less extent by reclamation, the stock of land is constant. It is therefore to be expected that established values will as a rule be steady. Again, in the centre of a populous community enjoying excellent transport facilities, the land will be capable of a variety of uses by a large number of people, and competition will result in a high value for the most profitable use; whereas away from the populous area the main element of value will be the natural fertility of the soil, and, if there is an abundance of such land, values will be comparatively low.

Although the rental value of developed land is affected by the economic movements previously referred to, it is the site which in the long run takes the benefit or burden of changes in conditions, for new building will be undertaken only so long as a sufficient yield on cost can be secured. Building cost depends on commodity values, and, therefore, the building rent must follow up changes in commodity values and current market expectations

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in the way of yield. If this yield is not forthcoming building will cease until either shortage of accommodation has forced up rack rents or ground rents are reduced enough to leave the desired return on the building.

The conclusion is that the portion of the rent applicable to the building must move in line with commodity values and market yields, whilst the rental value of the site, although tending to move similarly, will be subject to the enhancing and countering effects arising from the general state of trade or of profit levels, exaggerating or dampening the combined movement. For similar reasons, all annual taxation is really a charge on site rental values.

The rental value of residential property does not depend on the earning of profits on the land. Both employer and employee must, however, live somewhere, and residential property is complementary to commercial or industrial property; the use of the latter must therefore provide a sufficient profit and sufficient wages to cover the rent of housing. So far as the house itself is concerned, the rent must depend on building costs and market yields, but the rental value of the site depends on the standard of profits and wages and the cost of living in the district as determining the general ability to pay, and on the special attractions of the site.

The market value of real property depends on two things: (*a*) the rent which the property is capable of earning, and (*b*) the yield which an investor would expect, having regard to the degree of security of capital and income, the costs of acquisition, the trouble of management, and ease or otherwise of realization if later desired.

The rent which a property is capable of earning is a matter of the demand for the right to use that type of property and the state of supply; the yield which an investor would expect is again a matter of the demand for that type of investment and the state of supply. The property market is normally far less sensitive than the stock and share markets.

Real property used to be almost unique in being subject to compulsory acquisition, but with the spread of nationalization it no longer enjoys this singular but doubtful distinction.

Real Property v. Stock Exchange Securities

In comparing real property with Stock Exchange investments it is to be noted that, as a permanent holding, the former (excluding rent charges and the like) escapes the drawback of the

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fixed income security, for on the expiration of each lease the income can be adjusted to current values. In this adjustment it escapes the wider fluctuations of Ordinary share dividends because of the basic essentiality of land and buildings, with their anchorage to long-term tenancies rather than day-to-day variations of demand and prices. So far as the buildings are concerned, they suffer, in common with other commodities, from change of fashion and depreciation through use, but these factors operate slowly. In management, although the detail ought necessarily be left to the expert, there is direct control of policy. It is also worthy of note that rent depends not on one particular line of business, as may be the case with dividends. The security is what the average tenant would be willing to pay.

So far as rents are concerned, we are all guessing nowadays. In the City and West End of London almost any reasonably good office accommodation can be let at a yearly exclusive rent equal to 15s. to 20s. per square foot. A number of far higher rents are not unknown. But unless there is a long-term lease to a very substantial concern, nobody estimates capital values on rents of that order. The problem is the same as that which faces the steamship company about to build a new liner—what will she earn over the term of her existence? Scarcity has created high rentals, and if there is further inflation, these may become low rentals. On the other hand, further inflation may bring in more controls, whereas if we decide it is better to work harder than to want, national prosperity will return and with it perhaps some measure of deflation. The investor does not lose sight of the fact that interest rates have been held at an artificially low level, and he is not prepared (save on the high standing of a particular tenant) to take current asking rentals as a guide to future values.

Assume the following:—

That building cost in 1939 was £100

That a fair return in 1939 would have been 6%
thereon = £6 p.a.

That ground rental value was £3 p.a.

Therefore, 1939 rent of building and land = £9 p.a.

That future building cost will not be less than £200

That future interest rates will remain lower than
in 1939, say, $5\frac{1}{2}\%$ on £200 = £11 p.a.

That ground rental value will increase by 20%,
i.e., £3 plus 20% = £3 12s. p.a.

Therefore, future rent of building and land = £14 12s. p.a.

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This shows a 60 per cent increase on the 1939 rental. The higher the proportion of ground rent to rack rent, the lower the percentage increase in rack rents and vice versa, the answers ranging from 50 per cent where the ratio is one to two, to 70 per cent where the ratio is one to four or five. Each step in this working is, of course, sheer speculation, but when tying up capital all one can do is to estimate cautiously. The figures above may be incautious.

If an investor has bought $2\frac{1}{2}$ per cent Consols at 90, and thinks they are going down permanently, he may sell out at 80, buy in at the bottom of the fall, and wait for some recovery to wipe out his loss. If, however, for the sake of another $\frac{1}{2}$ per cent he has bought freehold ground rents at 3 per cent, by the time he has arranged to sell and found his purchaser, the market may already have touched bottom. Apart, therefore, from differences in security and trouble of collection and management as between interest on Consols and freehold ground rents, there must always be a seller's margin between the capitalization rates. The extent of the margin should not be regarded as fixed; when Consols are high (especially if pegged by Government manipulation) $\frac{3}{4}$ per cent is not too much, but when gilt-edged have steadied after a substantial fall $\frac{1}{2}$ per cent difference may be too much.

"Years' Purchase" Explained

THESE differences may seem small, but the number of years' purchase for 3 per cent equals 33.33, and for $3\frac{1}{2}$ per cent equals 28.57. Multiply a ground rent of £1,000 by the YP figures and the difference between first and second is £4,760, or one-sixth of the value at $3\frac{1}{2}$ per cent.

Some readers may not be familiar with the term "years' purchase". It means simply this: Suppose Mr. Bankbalance is offered an income of £100 per annum payable for ever, or, in technical language, in perpetuity. Mr. B. is willing to purchase the income but requires it to pay 5 per cent on his capital outlay. He will, therefore, be prepared to pay, ignoring costs of purchase, £2,000 or twenty years' purchase (or 20 YP) of £100 per annum, the multiplier being simply obtained from the fraction

—, where R equals the rate of interest required.

R

In dealing with property one has often to consider incomes which are receivable only for a fixed number of years, e.g., when

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buying a leasehold interest, or when buying a property which is let until, say, 1957 at £250 per annum and it is estimated that when the lease expires the property could be let at £450 per annum. In the first example the multiplier or years' purchase must allow for interest on purchase money at the desired rate, for the replacement of the capital laid out during the term of the lease (i.e., a sinking fund), and also for the fact that in the taxation of property under Schedule A no allowance is made for a sinking fund except in the case of industrial buildings. Thus assume that the income is £100 per annum for thirty years, that the investor requires 6 per cent interest besides replacement of his capital outlay over the term of thirty years, and that over that period income tax will average 7s. 6d. in the £.

In terms of an outlay of £1, 6% interest = £.06

Sinking fund to replace £1 in 30 years at $2\frac{1}{2}\%$
net (obtainable from tables of annual sinking
funds) = .0228

This sinking fund has to be provided out of
taxed income, and to have £.0228 available
with tax at 7s. 6d. in the £ the owner must
have an income of

$$\text{£} \frac{.0228 \times 20}{(20 - 7.5)} = .0365$$

Therefore £1 of capital requires an income of £.0965

$$\text{Years' purchase} = \frac{1}{.0965} = 10.36 \text{ Y.P.}$$

Therefore if the investor pays £1,036 for an income of £100 receivable for thirty years he will receive 6 per cent interest on his outlay and be able to replace his capital during the term.

In the second example the appropriate multipliers can usually be taken direct from Tables of Years' Purchase in the case of freehold interests, but a different procedure would be necessary in the case of leasehold interests. Even in the case of the freehold, complications sometimes arise necessitating a different procedure, e.g., where a rent of say £500 per annum is payable until 1962, and after that it is considered that the maximum likely to be obtained under a new lease is £350 per annum or perhaps only a ground rent value of £100 per annum. Part of the property purchased in such an instance is a wasting asset, and provision for writing off must be made.

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Main Types of Property Investment

Freehold Ground Rents.—A ground lease is usually granted for a term of ninety-nine years. During the early years of the lease the remote reversion to the rack rent at the end of the lease is usually ignored and the ground rent alone is valued as if receivable in perpetuity. The investment is therefore comparable with a perpetual fixed interest investment, but with the benefit of prospective ultimate appreciation if held for permanent investment. When, however, the unexpired term of the lease shortens, and certainly when it is less than sixty years, the value of the reversion to the developed property becomes ponderable, and the valuation of the freehold will be the estimated present value of the ground rent receivable for the unexpired term of the lease, plus the estimated present value of the reversion.

The foundation of this practice is that in the past there has generally been the prospect of a greater value at the end of the term, either by a reversion to buildings or, if these were worn out, to a ground rent higher than the rent payable under the lease, owing to the general fall in the purchasing power of money over a long period or to improvement in the "position".

The words "in the past" are important. For some time there has been pressure for the imposition on all buildings of a "life", and although this has not been adopted in the Town and Country Planning Act, 1947, the idea cannot be regarded as dead. Thus it used to be reasonably safe to assume that the value of the land itself would be higher at the end of a ninety-nine years' lease than at the beginning, but when a town planning scheme may shift the main shopping centre, and when a falling population is prophesied (apart from possible Commonwealth emigration from this country) which may reduce the demand for residential land, that assumption may no longer be wise.

It is generally reasonable to assume that the buildings will last out the term of the lease, and the right of forfeiture does create a very real measure of security for income during the term.

A special reference is necessary to what are known as "created" ground rents. These are not ground rents reserved on the grant of a building lease, but arise as follows:—

A speculator (individual or company) acquires a site and develops it, and having substantially let the buildings (usually a block of flats or offices) offers to sell the property on the basis that the vendor is to take from the purchaser a long-term lease of the property, usually ninety-nine years, at a rent substantially

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less than the estimated full earning capacity of the developed property. The purchaser thus acquires a freehold income over which there is initially some margin of security, but the income is usually much greater than the true ground rental value of the site, and it lacks the full security of a true ground rent.

Chief Rents lack the appeal of ground rents, there being no prospect either of appreciation (owing to the absence of a reversion) or of ability to adjust the income from time to time.

Leasehold Ground Rents are less attractive because they are receivable for a limited term, and there is no reversionary element. It is, therefore, necessary when acquiring them to bear in mind that, out of the rent, a sinking fund must be set aside for replacement of capital at the end of the term. Allowance must be made for the fact that the amount so set aside does not rank as an expense for income tax purposes. In addition to the payment of the ground rent reserved in his lease, the owner of a leasehold ground rent will usually have liabilities to the freeholder for repairs and the observance of restrictions. Although liability for these matters may have been passed on to the under-lessee, the lessee remains liable to the landlord and must make good any default by the under-lessee.

This is a type of security which is not generally sought after by investors unless it can be married to an interest already owned, such as a freehold ground rent or leasehold rack rent. When the unexpired term is short there is practically no demand, whilst the cost of dealing with dilapidations and all other problems is increased by the freeholder serving the lessee and the lessee serving the under-lessee, usually involving three firms of solicitors, with three surveyors trying to come to agreement.

Freehold Rack Rents vary very greatly in quality according to the nature of the occupation, the age and constructional standard of the building, and the position. Being close to the full rental value of the property, these rents are susceptible to conditions of prosperity or depression. They benefit most directly from inflationary trends, subject to the unexpired terms of the leases that exist, and are therefore more closely comparable in this respect with Ordinary shares. The degree of fluctuation on the return is, however, much less severe. The risk of loss of rent from bad debts is greater than in the case of freehold ground rents, since the tenants have less at stake, and there is the additional possibility of loss through "empties". Rents are liable to fluctuation arising from a multiplicity of reasons, some affecting all classes of rack rents and some affecting particular types

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only—state of trade, relationship of earnings to cost of living, changes in transport, changes of fashion or habit, entry of multiple traders, restrictions on user. The rent of a building tends to conform to commodity prices, and therefore the owner is likely to suffer less from a reduction in the purchasing power of money than in the case of a fixed income investment. Against this, the rent of the building is not recoverable in perpetuity, and strictly, allowance should be made for obsolescence. So far as industrial buildings are concerned there is a tax allowance for this purpose under the Finance Act, 1945, but in making the sinking fund allowance in respect of other buildings it should be “grossed up” as shown earlier in this chapter.

It is unusual to find an obsolescence allowance made in the valuation of a building unless it is very obviously suffering from age or unsuitability to the site, and the usual practice of the market is to sum up all the foregoing factors in any particular case and give the answer in the form of the percentage yield required in that case, much as an investor in stocks will weigh up the merits of a particular stock, decide the yield he requires, and thence calculate whether he is prepared to pay the price quoted.

Rent is in a somewhat similar position to dividends on Preference shares, but, whereas the security of income in the case of the shares must be measured solely in relation to its particular source, the security for rent (apart from the value of any covenant) must be measured against what the average tenant would pay if the property comes into hand. If the rent is above what the average tenant would pay, the excess can only be valued as dependent upon the credit of the particular tenant and the basic rent valued according to the average demand. Where, however, the tenant is exceptionally strong, such as one of the leading multiple firms, the security for the whole income afforded by the tenant's covenant may exceed the degree of security one would usually associate with a property of the class in question, and the valuation will, in effect, become less a valuation of property than of the tenant's ability to make a particular yearly payment.

Where the rent is less than what the average tenant would be willing to pay, the valuation will bring into account the probable reversionary increase, and since, in the case of rack rents, one is usually dealing with terms no longer than twenty-one years, the estimation of reversionary value is a matter of greater certainty than in the case of a ground lease.

Leasehold Rack Rents arise when either a ground lessee or a rack rent lessee sub-lets. The latter's interest is too speculative to be

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considered here, and we will confine our observations to the case of the ground lessee entitled to a rack rent.

His income is receivable for a limited term and the necessity for amortization arises. Indeed, the considerations in this respect are the same as in the case of leasehold ground rents, except that the income is flexible according to the term of the rack rent lease. If the unexpired term of the ground lease is long the lessee's income can generally be adjusted to keep step with economic changes.

Companies which specialize in the development of commercial buildings often favour the leasehold interest, as even after making provision for amortization they can secure a higher yield, although this is, of course, more subject to variation than if the freehold had been retained. Not only must the ground rent be paid when the buildings are wholly or partly empty, but the sinking fund must be kept up and the lease covenants observed and performed.

Types of Rack Rent Property

THE following remarks are chiefly concerned with the principal types of rack rent in the London area, but are equally true of many other areas.

Shops.—There is no doubt that before the war many areas were "over-shopped" and rents were in consequence unreliable. The future of London shop rents must depend on the extent to which decentralization may be decided upon, and the best investment at the present time is probably to be found in the shopping centres of the newer residential areas around London rather than in the County of London itself. The smaller towns also stand to profit by decentralization of the larger areas. It is, however, probably a safe prophecy that the West End will always be the Mecca of shoppers, and that rents there will not relapse. The same may be said of the main provincial shopping centres.

Shops may be regarded as very suitable for investment provided careful selection is exercised. Shops in well established positions should always command good rents. Little management is required, as the tenants are usually made responsible for repairs and the payment of outgoings. The principal complications which may be met are the Shops Act, 1934 and the Landlord and Tenant Act, 1927.

Offices in central areas should always be in demand, but an unregulated continuous rebuilding of London to a greater height

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than the old London might well result in an excess, and this is true of other areas. Town planning restrictions on height and site cover are therefore a safeguard to owners, although not usually looked upon in that light. It is possible that the future tendency in London will be towards the big block well spaced or with ample courtyard for lighting and ventilating the inner rooms, and with adequate road access for persons and goods. This would lead to less coverage by buildings, and would help to offset any tendency to an excess of accommodation being provided as a result of greater height.

It used to be said that many firms which left London during the war had no intention of returning, but the prestige and advantages of being located in the capital, or in the centre of a leading provincial city, have caused a good deal of weakening in this resolution. On the whole, modern office buildings in central business positions may be regarded as secure investments. Good management and willingness to modernize are important if satisfactory results are to continue.

Blocks of Flats.—Flats let at rents up to £300 per annum can in London come within the existing measure of rent control. Nevertheless, ultimately some modification of the Rent Restriction Acts may reasonably be expected in favour of flats, as in most cases a large proportion of the rents represents charges for landlord's services, such as portage, lifts, central heating, constant hot water, etc. The demand for flats is a growing one, and although there may be cycles of overbuilding when income will possibly fall off they may, in the long run, be regarded as a sound investment. Town planning control should in future prevent to a great extent these cycles of over-building. It is, nevertheless, to be borne in mind that pre-war experience was that the income from first lettings in a new block of the higher rented type of flats was usually more than that secured on subsequent re-lettings. In the provinces the possibilities of flats, other than those for the working classes, are practically unexploited.

Efficient management is vital, and this factor cannot be too strongly emphasized. There must also be a willingness to spend money on keeping the buildings up to date if the best results are to be obtained.

Dwelling Houses.—Residential areas are particularly subject to changes of fashion, as may be seen in the inner part of most towns and much of the outer part of large towns. There is, too, a general tendency for a decline in values to occur as soon as the newness

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has worn off a property, although this is possibly less noticeable in relation to rents than capital values; buyers want and are prepared to pay for the latest. House rents are also to some extent artificial owing to the very general under-assessment of houses for purposes of rating. The adjustment of these assessments in accordance with the true intent of the Rating and Valuation Acts might have serious repercussions on the rental levels, but a reasonable level of future assessment seems now to be assured by the Local Government Act, 1948. The new valuation lists for 1952 are to be based substantially on 1938 values, i.e., they will start fourteen years out of date.

Furthermore, the wide control of residential rents by the Rent Restriction Acts, irrespective of the level of commodity values, is a discouraging factor to private investment. On the other hand, the housing shortage, which is likely to continue for some years, makes these rents well secured as an investment, and the re-planning of areas may tend to stop the past steady decline of residential areas in the inner suburbs. Improvement in the level of controlled rents will probably be allowed when Parliamentary time for legislation can be found, and this adds to the general security of the investment.

Dwelling houses are not as a rule considered attractive to big investors on account of the trouble and expense of management. Again, the building societies encourage owner-occupation and, with some reservations, this is in the national interest. But dwelling houses offer an investment outlet to the small investor as the most essential form of real property. Apart from the complexities of the Rent Restriction Acts, and, less frequently, the Housing Act, 1936, house property is reasonably straightforward in management, but familiarity should not lead the investor to overlook the need for a report by a qualified surveyor, and he must certainly take advice as soon as he begins to feel out of his depth.

Factories and Warehouses, being "special purpose" buildings, have not in the past been favoured as investments. Short life due to heavy wear and tear and other causes, and the risk of "empties", also play their part. On the other hand, concentration of industrial buildings in suitable areas in accordance with replanning proposals may make for a greater sense of security. For the present, however, this class of property is best left out of our reckoning except as a mortgage or Debenture security where the premises are owned and occupied by or leased to a going concern. The Factories Act, 1937, is the principal legal com-

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plication. But the allowance for obsolescence under the Finance Act, 1945, makes this type of investment a little more attractive, especially when the lessee is a firm of substance.

Agricultural Land.—The rental value of this fundamental commodity depends on the fertility of the soil and the proximity of the market for its produce. The type of tenant and the owner's estate management also influence the value to an appreciable extent. Indeed, the importance of the last two factors is too often overlooked. The bad or inefficient type of tenant who does not keep his land in good heart and the lethargic owner who allows the land and farm buildings to deteriorate are frequent causes of depreciation of value. Conversely, the acquisition of land which has been subjected to either or both of these influences offers good prospects of capital appreciation to an energetic and far-seeing purchaser. The law of agricultural holdings has been the subject of extensive amendment recently, while the Government policy on agriculture is of first importance.

Accommodation Land.—This is open land, usually on the outskirts of a town, having an urban value as a sports field, grazing land for a butcher, allotments, etc., but not a matured building value. It is often difficult to value. It must be ascertained that the use is one which is likely to continue, or that the same rent can be obtained for another purpose, for which town planning consent will be granted (it should also be ascertained whether the change of use will involve payment of a "development charge"). In the London area, for example, there is a shortage of good playing fields. If land is accessible and has been reasonably well prepared for the purpose, it can be considered as a secure investment, especially as it will almost inevitably be in demand as prospective building land, again subject to town planning restrictions and almost certainly to "development charge".

Building Land.—Building land, other than a site in an established business area, is an extremely speculative item to value. Its development is hedged about with town planning and other proposals about which there is a growing volume of uncertainty, whilst industrial movements, new transport routes and other factors may completely falsify an estimate of prospective building value. The value of building land is also dependent on the cost of laying out the roads and sewers and other initial works, a cost which varies according to the skill of the person planning the layout and the cost of the material and labour required.

Naturally enough, too, the developer requires a profit on his outlay, usually about 15 per cent. But if the land is fully ripe and

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building is booming, he may be satisfied to pay more for the land and take a smaller profit, while if the boom is checked before the land is developed the next buyer will not only desire to treat the building value as deferred for some years (discounted according to current interest rates), but will consider the whole risk so much greater that a higher developer's profit will be sought. He will also wish to allow for possible increases in the cost of road and sewerage works, etc. Big profits have been made in such transactions—and equally big losses. In future, when building land is purchased for development, there will be the “existing use value” to be paid to the owner for the land restricted to its old use and a “development charge” to be paid to the Central Land Board for the right to carry out development. There would seem to be little future in speculation in building land except by developers who may make a profit out of their skill in carrying out the development. It can no longer be considered as an investment except on the basis of its existing use.

It will be appreciated that in the main this chapter deals with property conditions in England and Wales. Scottish property law and practice differs in many important respects.

CHAPTER XIII

INVESTING THROUGH THE POST OFFICE

Some safety-first investments—Simplicity of National Savings Certificates—Their growth in value—The tax-free feature—Certificates as income producers—The eighth issue—The seventh and earlier issues—Post Office Savings Bank—Its facilities for gilt-edged investments.

THIS is essentially a "safety first" chapter. It deals with British Government investments and bank deposits mainly effected through the Post Office. First let us consider National Savings Certificates.

Many years ago someone coined an apt phrase regarding National Savings Certificates by describing them as "the spoiled darlings of the Treasury". It is an appellation that holds good to this day. No other United Kingdom investment is truly free from deduction of income tax from the interest thereon—or rather, in the case of National Savings Certificates, from those additions to capital value which with this unique British Government investment take the place of the conventional interest payments on other British Government securities. (The only qualification to this statement that the certificates are unique relates to Tax Reserve Certificates, which do not concern small investors.)

Whether our investor is a plutocrat or just one of the lesser fry, it will be to his advantage to take up as many National Savings Certificates as the regulations governing these securities permit; for were there no limit to the individual holding the resultant wholesale escape from income tax liability would soon be remarked in the Exchequer Returns. As it is, the upper limit is set at a point which provides a reasonably substantial personal holding for the individual who is thrifty; while hardly any sum is too small to be invested in a few units of the eighth issue of the certificates—the only issue now available for new purchases. The certificates are intended as an investment for individuals only, and are not available for companies, etc.

Simplicity may be claimed for the principles underlying the savings certificate, which as a result has always been very popular with the small investor since its introduction during the 1914-18 war. The Eighth Issue, first put on sale in April, 1947,

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costs 10s. per unit, and may be held for ten years from the date of purchase. During those ten years the value per unit gradually increases to 13s. Only 2d. per unit addition to value is made at the end of the first year. But from then on an addition of 1d. per unit is made for each completed period of four months (i.e., 3d. a year) until the end of the third year. And then, to the end of the tenth year, each completed period of three months brings an addition of 1d. per unit.

In case this seems complicated, we will set out in tabular form the value at which single units can be cashed at the end of each year, and also the aggregate value of the maximum Eighth Issue holding of 1,000 units (purchase price £500) at the end of each year. But it should be emphasized that (apart from the first year of the life of these certificates) the cash value increases not once a year, but at intervals of four months up to the end of the third year, and thereafter at three-monthly intervals as above defined.

EIGHTH ISSUE SAVINGS CERTIFICATES—GROWTH IN VALUE

Age years	Value 1,000* units will be		Value per unit	Age years	Value 1,000* units will be		Value per unit
	£	s. d.	s. d.		£	s. d.	s. d.
1	508	6 8	10 2	6	583	6 8	11 8
2	520	16 8	10 5	7	600	0 0	12 0
3	533	6 8	10 8	8	616	13 4	12 4
4	550	0 0	11 0	9	633	6 8	12 8
5	566	13 4	11 4	10	650	0 0	13 0

*Original purchase price £500.

These increases in value are technically regarded as additions to the capital value of the certificates—hence their freedom from income tax deduction. And with no return obtained on a holding until it is actually cashed (which operation can be effected at any time during the life of the certificates) the return on the security is in the nature of compound interest (as distinct from the simple interest accruing where a conventional stock pays interest at, say, half-yearly intervals).

Owing to this special characteristic of the savings certificate, the effective rate of interest on the Eighth Issue units (if held for the full ten-year period) is to be regarded as £2 13s. 2d. per cent per annum compound interest, tax free. Where an investor is liable to income tax at 9s. in the £, this rate is equal to £4 16s. 8d. per cent gross compound interest—a decidedly attractive return for a British Government security and one which is, of course, increased if the recipient should otherwise be liable to sur-tax.

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(An additional attraction for those unresponsive to the chances of capital appreciation lies in the fact that the certificates are insulated from the capital depreciation seen from time to time on the Stock Exchange in many gilt-edged stocks.)

An Income Plan

BUT what of the investor (particularly the small investor) who wishes to regard his savings certificates as an income producer, and not merely as a secure lock-up of his money for ten years? Can he arrange matters so as to draw the equivalent of annual interest at regular intervals from his savings certificates and still leave his original capital intact? Certainly he can, by the exercise of a little skilful planning. Since certificates can be cashed at any time during their life (ten years for Eighth Issue certificates under present arrangements) it is possible to draw what amounts to regular tax-free interest by a judicious cashing of a portion of the holding from time to time. Assume a holder has the maximum holding of 1,000 certificates bought on 1st June, 1948. These will have cost him £500 at 10s. per unit. He must contrive, as nearly as possible, to hold at 1st June, 1958, ten years later, as many units as will then (at 13s. per unit, the value after ten years) still be worth £500.

At 13s. per unit 770 certificates will on 1st June, 1958, have attained a value of £500 10s., which is near enough for practical purposes. So our investor can cash 230 certificates (i.e., 1,000 less 770 retained) at intervals over the ten years. There is scope for careful planning of the scale of the realizations in view of the smaller cash additions to unit values in the earlier years of the ten. The average number of units realized will be twenty-three each year, but there can be permutations in these numbers, which will tend to cause slight variations in the effective net income secured by this periodical cashing plan. One possible scheme is outlined in the second table.

Under this plan, it will be seen, 25 certificates are cashed at the end of the first year, then 24 at the end of each year from the second to the sixth, and so on, reducing to 20 cashed at the end of the tenth year, when the investor will be left with the 770 units.

Certificates are issued not only as single units, but also in the form of multiple documents representing two, three, four, five, ten, twenty-five, fifty and one hundred units. Our investor in 1,000 units, if he bought them all at once, would hold ten multiple certificate documents, each representing 100 units.

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How then is he to cash blocks of 25 or 24 units, and so forth? This is provided for in Post Office regulations, since in the case of multiple certificates repayment with accrued interest may be obtained of one or more units out of the multiple document.

INCOME PLAN FROM 1,000 EIGHTH ISSUE CERTIFICATES

End of	Value per unit	Number of units to be sold†	Proceeds of year's sales	Year's growth in value if all retained‡
	s. d.		£ s. d.	£ s. d.
1st year	10 2	25	12 14 2	8 6 8
2nd year	10 5	24	12 10 0	12 10 0
3rd year	10 8	24	12 16 0	12 10 0
4th year	11 0	24	13 4 0	16 13 4
5th year	11 4	24	13 12 0	16 13 4
6th year	11 8	24	14 0 0	16 13 4
7th year	12 0	22	13 4 0	16 13 4
8th year	12 4	22	13 11 4	16 13 4
9th year	12 8	21	13 6 0	16 13 4
10th year	13 0	20	13 0 0	16 13 4
	Totals	230	131 17 6*	150 0 0

*Average annual proceeds of sales say, £13 3s. 9d., equal to about 2½% net interest on £500 original purchase price, or to over 4½% gross with income tax at 9s. in the £. †From 1,000 unit holding. ‡Assuming retention of 1,000 unit holding intact.

The last column in our second table will help the reader to judge the comparative merits of using the 1,000 certificates as an annual income producer, yielding net interest totalling £131 17s. 6d. by ten annual instalments, and of holding them intact for the full ten-year term and thus securing £150 tax free addition at the end of the period to the £500 originally invested. Additions to the value of the units are often so framed as to produce some slight falling off in the later years of their life in the compound interest rate yielded—for example, this is the case with those early issues which now receive a flat addition of 1d. per month per unit. This unchanging addition, of course, produces a gradual (if almost imperceptible) *decrease* in the current net interest yield on a capital value which is *increasing* all the time. But on the Eighth Issue investment contemplated in our example the average *net* annual compound interest rate in the first five years is just over 2½ per cent; and on the £566 13s. 4d. capital value outstanding on an intact 1,000 unit holding at the end of the fifth year, the next five-year period will bring an increase in the annual *net* rate to over 2½ per cent.

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Earlier Certificate Issues

THOUGH only Eighth Issue savings certificates (discussed fully on pages 198 to 200) are now available for purchase, there are ten issues in the hands of investors, the First Issue having been put on sale on 21st February, 1916, and having been followed by the Second, Third, Fourth, Fifth, Sixth, Seventh and Eighth Issues. There are also the Conversion Issue of 1932 and the £1 Issue that was on sale from 1943 to 1947. The Conversion Issue reflected Mr. Neville Chamberlain's great Government debt conversion operation of 1932. The £1 Issue was made available to those who already had their quota of 500 units made up of any combination of the series then extant, and its terms were correspondingly somewhat less generous than is customary.

This galaxy of issues reflects the alterations in interest rates on British Government securities generally. But all along the income obtainable from National Savings Certificates has been kept on a very attractive basis relatively to the general level of interest rates, in order to strengthen the appeal to the small investor. And, despite occasional temporary setbacks, what a remarkable appeal they have exercised! In the ten years to the end of March, 1947, the total outstanding (ignoring accrued interest) rose from £390 millions to £1,673 millions. If we include accrued interest, and allow for the certificates cashed, it is found that at 30th June, 1948, the total remaining to the credit of investors was about £2,110 millions. The total number of certificates purchased since their inception in 1916 was over 4,147 million units up to 30th June, 1948.

Many holders of National Savings Certificates will have accumulated a mixed bag in which several different issues are included as a result of steady saving over a period of years. How accretions in value work out in such a case must be a matter for individual calculation, since the terms of the different issues vary. But here is the experience of one holder with a total of 493 unit certificates of various issues, purchased between 1922 and 1934, and then left unaltered until 1947. By 1935 this holding had become worth £536, but by 1947 the value had grown to £770—an increase of over 43 per cent since 1935.

The average annual addition to the value during the thirteen years was £2 18s. 7d. per cent net, equal to £5 7s. per cent gross where income tax was borne at 9s. in the £—though, of course, the spread between net and gross equivalent was much smaller in the pre-war years, when income tax was lower.

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The current yield on the older issues is subject to almost infinite variation, according to the age attained by a given holding of units; and it also depends on the growth in the values attaching to the respective series of certificates. Over the next ten years (if we start from a chosen datum line at 30th June, 1949, so as to provide a uniform comparison) the net returns on those of the older issues which it is known can be retained for that period range from about £1 17s. 6d. per cent compound interest on the oldest units of the First Issue to about £2 16s. per cent on the youngest units of the Conversion Issue. These amounts are, of course, calculated not as interest rates on the original purchase price of the units, but as the future interest rates on the capital value which each individual unit will have attained on 30th June, 1949. They relate strictly to the ten-year period indicated. A shorter period of retention may give somewhat different results.

Full details of procedure in regard to purchase and sale are given in free official leaflets and also in the Post Office Guide, obtainable for 1s. at most post offices. Therein will also be found the rate of growth in the value of all issues. A booklet published at 1s. 3d. by the Davis-Jones Co., 77 Higher Bridge Street, Bolton, Lancs., gives details of the value of certificates at a very full range of different ages (including fractions of a year) for all ten issues. Its title is "The Values of Your National Savings Certificates at a Glance".

The time during which the Seventh Issue certificates were on sale coincided with the great war-time savings drive, the offer of this issue starting on 22nd November, 1939, and ending on 31st March, 1947. Hence the rate of growth in value of the Seventh Issue must interest an exceptionally large number of savers. The accompanying table shows the value at different ages of this issue, the certificates of which must have been at least one year old on 31st March, 1948; and a plan for cashing certain certificates from a holding of 500 (the maximum in this case) so as to secure a regular income is indicated.

If adopting the income plan, the holder must see to it that he retains certificates worth £375 at the end of the ten-year period, that being the original cost of 500 Seventh Issue certificates at 15s. per unit. Under the plan he cashes 134 over the ten years, and still holds 366 at the end of the period, then worth £375 3s.

Since Seventh Issue certificates were not on sale after 31st March, 1947, it will be appreciated that to carry out the above plan precisely as set out here would entail commencement of cashing units on 31st March, 1948, so that it would already be in

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operation at the time of publication of this book. But the table will still serve to illustrate the procedure under this income plan, which can easily be adjusted to individual requirements.

INCOME PLAN FOR SEVENTH ISSUE CERTIFICATES

End of	Value per unit	Sales from 500 unit holding		Year's growth in 500 units*
		No. of units	Proceeds	
	s. d.		£ s. d.	£ s. d.
1st year	15 3	15	11 8 9	6 5 0
2nd year	15 9§	15	11 16 3	12 10 0
3rd year	16 3	14	11 7 6	12 10 0
4th year	16 9	14	11 14 6	12 10 0
5th year	17 6	13	11 7 6	18 15 0
6th year	18 0	13	11 14 0	12 10 0
7th year	18 6	13	12 0 6	12 10 0
8th year	19 0	13	12 7 0	12 10 0
9th year	19 6	12	11 14 0	12 10 0
10th year	20 6	12	12 6 0	25 0 0
		Totals 134	117 16 0†	137 10 0

*Annual growth in value of 500 units if retained intact. Total growth in ten years is thus from £375 to £512 10s.—equal to £3 3s. 5d. per cent per annum net compound interest. †Average annual proceeds £11 15s. 7d., equal to £3 2s. 10d. per cent per annum net. §Youngest units of this series attained value of 15s. 9d. on March 31, 1949.

In December, 1948, in anticipation of the oldest certificates of this series attaining their ten-year value of 20s. 6d. on 22nd November, 1949, it was officially announced that the life of all certificates of this series would be prolonged for a further twelve years, with the value increasing at a flat rate of 3½d. per unit every six months, so that at the end of twenty-two years from the initial date of purchase of a Seventh Issue certificate at 15s. it will become worth 27s. 6d. The net compound annual rate of interest on this basis will be £2 9s. 7d. per cent for the last twelve years of the twenty-two. In the first ten years, as shown in the table, it was £3 3s. 5d. per cent, and so, if held for the whole twenty-two years from initial purchase, Seventh Issue certificates will give £2 15s. 10d. per cent per annum net compound interest.

The maximum individual holding is 1,000 10s. units of the present Eighth Issue certificates, plus 250 units of the £1 issue, plus 500 units of the old 15s., 15s. 6d. and 16s. units combined—the last group representing the older issues mentioned above. Just a reminder may be added that the interest on savings certificates (all issues), being free of U.K. income tax, need not be included in a U.K. income tax return.

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Post Office Deposits

SAVINGS certificates are the main investment medium handled by the Post Office, but an account in the Post Office Savings Bank itself has its advantages. Such an account, no matter where it was opened, can be operated at any one of the 18,000 savings bank post offices in Great Britain, Northern Ireland, the Channel Islands and the Isle of Man.

Total deposits in any one calendar year are restricted to £500. A depositor may have more than one account, but the total standing to his credit in all accounts must not exceed £2,000—unless the excess existed before 5th November, 1946. The limits do not prevent the crediting of an account with interest on deposits or on Government stock or bonds held on the Post Office register. Withdrawals of £3 on demand are possible, but the procedure for withdrawing larger sums is less expeditious and less simple than drawing a cheque on an ordinary banking current account. But whereas such current accounts do not earn interest nowadays all Post Office Savings Bank deposits bear an invariable $2\frac{1}{2}$ per cent per annum gross interest—an attractive rate for bank deposits in present times. Trustee Savings Banks offer somewhat similar facilities, comparable security and more liberal withdrawals on demand—up to £50 can be withdrawn on demand from one's own branch. It is apparently not generally known that a £50 withdrawal on demand can also be made from a Post Office Savings Bank account—but only by personal attendance at the head office of the Bank at Blythe Road, Kensington, London, W.

Nearly thirty British Government stocks are held on the Post Office register as well as on the Bank of England register, and purchases and sales of these can be made through the Post Office Savings Department. Income tax is not deducted at source on interest paid on investments made through the Post Office, and this is a useful facility for small investors not liable to the full 9s. rate of tax; another is the option for automatic crediting of dividends to a Post Office Savings Bank account, where such credits will bear $2\frac{1}{2}$ per cent annual interest along with normal deposits.

Defence Bonds (not marketable through Stock Exchange channels) are a short-term investment sold through the Post Office and through Trustee Savings Banks. The recent decline in British Government credit has rendered these issues less attractive than they were. The old 3 per cent issues, no longer on sale,

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are being converted to the $2\frac{1}{2}$ per cent rate (gross) as they fall due for repayment. The present $2\frac{1}{2}$ per cent issue is repayable at 101 per cent ten years from the date of purchase, but can be encashed at par (plus accrued interest) earlier on six months' notice, or without notice less $1\frac{1}{4}$ per cent discount. The maximum individual holding of all issues of Defence Bonds is £2,500.

CHAPTER XIV

POINTS ABOUT INCOME TAX AND PROFITS TAX

Heavy U.K. tax burden—Mostly borne by ordinary shareholders—Tax deduction at source—How tax repayment claims arise—Converting net dividends to gross—So-called “tax free” dividends—Building society interest—Double taxation relief—Recent changes—Net U.K. rates and their implications—Profits tax—Its drain on re-equipment provisions—The equity shareholder pays—High profits distribution penalized—Need for more tax reforms.

IN a speech to trade unionists in May, 1948, Sir Stafford Cripps emphasized the fact that profits were already taxed very heavily, and that the full effect of the increase in taxation of company profits would only be seen after quite a long interval. He noted that profits tax along with income tax takes a good deal more than half of all distributed profits. And since that speech was made there has been increasing realization of the difficulties created by this tax structure.

Illustrating Sir Stafford's remarks, we can show that taking income tax and profits tax together, a U.K. company is normally paying 10s. or 11s. in the £. Holders of fixed interest securities in such companies—Preference shares and the like—suffer deduction of income tax at 9s. in the £ from their dividends. And holders of Ordinary shares, besides bearing the same 9s. per £ dividend deduction, in effect bear all the rest of the company's tax liability, since a company pays tax on the whole taxable profits—not merely on those distributed as dividends. Ordinary shareholders do not pay any more tax direct, of course, (although their dividends may be subject to sur-tax), but the value of their reversionary interest in the company is prejudiced first by the effect of profits tax in diminishing earnings on Ordinary capital; next by the inroads which taxes nowadays make on retained profits put back into the business; and lastly by the fact that re-equipment, and consequently future earning capacity, is gravely imperilled by such inroads.

No doubt many a shareholder merely notes the direct impact of income tax on his investments by deduction of tax “at source” from his dividends or interest. Except for some special cases like

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British Government securities of any amount held on the Post Office Register (where it is the custom to pay over interest at the gross rate), the standard rate of U.K. income tax is deducted from the gross amount of all dividend or interest payments.

Suppose the taxpayer has £100 (par value) invested in a certain company's Ordinary shares, and suppose this company declares 10 per cent dividend. The gross amount will be £10 on £100 par value, but with income tax at 9s. in the £ there will be a deduction of £4 10s. tax from the gross payment, so that the dividend warrant will be made out at its net amount of £5 10s. With the dividend warrant the company is legally bound to provide a certificate showing the gross amount of the dividend, the rate of income tax deducted, the amount of such tax and the net amount of dividends paid over to the shareholder. This is useful if the shareholder has any claim upon the Inland Revenue for a repayment of income tax deducted from his dividend.

Whether the investor has such a claim must depend on his individual circumstances, but repayment will sometimes arise from the fact that the amount of tax deducted from dividend income exceeds the taxpayer's total liability for the income tax year in question. Supposing that the total gross dividend income of the taxpayer for the year from his various investments is £100, the income tax deducted (at 9s. in the £) will be £45. This £45 tax may (in his particular circumstances) exceed his total tax liability for the same year as determined after allowing for earned income relief, personal allowance and so forth. If his net tax liability is, say, £30 for the year, he will have a claim for repayment of £15, since £45 tax paid by deduction from his dividends exceeds by £15 his true liability of £30.

The fact to keep in mind in estimating one's tax liability in such cases is that from the point of view of the Inland Revenue this dividend income swells the total income of the taxpayer from all sources not by its net amount of £55 (£100 less £45 income tax) but by its gross amount of £100. These dividends must be entered in the return of income at that gross amount of £100, and the Inland Revenue, in arriving at the taxpayer's liability, will take into account the fact that the £100 has borne tax of £45.

This is the position in mere outline, but there will commonly be intricacies arising either from the circumstances of the individual taxpayer, or from the nature of his dividend income. A few examples may be quoted.

It is sometimes difficult for the taxpayer to ascertain the gross amount of his dividends, and if the calculation baffles him for

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one reason or other he is permitted to enter the net amount; this will be converted to its gross amount by the Inland Revenue experts.

Now that much Dominion tax relief is being given in a new way (of which more anon) the old difficulties of calculation arising from the deduction of U.K. income tax at a rate less than the standard amount should have been greatly diminished, but there is still the problem of the correct gross amount to be attributed to certain classes of net dividend payments from companies resident overseas—an outstanding example being South African resident companies which have to deduct the non-resident tax levied there on payments to shareholders resident outside South Africa. Bearing in mind also the allowance made for other South African taxation, the business of calculating the remaining liability for U.K. taxation and the gross amount of the dividend (as regarded from the point of view of our Inland Revenue authorities) becomes complex indeed. So complex is it that the various South African mining groups make a practice of publishing advertisements each half-year, primarily for the benefit of holders of share warrants to bearer, which explain all the steps in the calculations for each of their companies. Among other things these notices clearly show the gross amount of the dividends as adjusted for the purpose of U.K. tax liability, and also the net amount being paid here.

Another complication when calculating the investor's gross income from all sources is the so-called "tax free" dividend. A steadily diminishing band of companies sticks to this old-fashioned method of declaring dividends "tax free"—though we must acknowledge the fact that certain Dominion tax complications in recent years forced some companies over to this generally speaking outmoded system. From many points of view it is good that the practice is declining. These dividends are not tax free in the true sense of the phrase. While income tax is at 9s. in the £ the declaration of a dividend at $5\frac{1}{2}$ per cent tax free (for example) means exactly the same thing as the declaration of a dividend at 10 per cent less tax. In any event, this should be clear from the company's statement of the gross and net amounts of the payment sent out with dividend warrants. So the shareholder, if he receives a £55 net payment in respect of a "tax free" dividend of this type, will be in order if he regards it as really a £100 gross payment which has already had £45 income tax deducted from it by the company before he received it.

The exceptional position of interest on investments in building

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societies is worth noting. Practically all building societies have adopted the long-standing special arrangement with the Inland Revenue whereby they declare their dividends or interest at a given rate per cent clear of tax, and pay income tax on the dividends on behalf of the shareholder or depositor at a rate lower than the standard rate. In consideration of this concession as regards the rate of tax, no claim by individual shareholders or depositors for repayment of tax on building society investment interest is admitted. The arrangement relieves the Inland Revenue from a swarm of small repayment claims, since building societies have been regarded as one of the main channels for small investments. So in entering any interest on building society investments the taxpayer will remember that £50 received from such a source is £50 to enter in the return of income unaltered. But it is £50 net, and will not be taxed again.

This book being designed primarily for the small investor, it should be noted that no attempt has been made to deal here with the position from the standpoint of sur-tax payers.

Double Tax Relief

Now we must attempt to deal with recent developments in the sphere of double taxation—a subject full of pitfalls. Here we can set forth none of the elaborate formulæ in which tax experts revel, nor can we give more than a mere sketch of a matter which has important aspects for investors—large and small alike.

Detailed examples of the way in which double taxation arrangements work were given by an expert in two special articles which appeared in *THE INVESTORS' CHRONICLE* during 1948 (17th April, 1948, page 682, and 24th April, 1948, page 732); and those who are not intimidated by a mass of mathematical tables might well consult these.

Since the passing of the Finance (No. 2) Act 1945 certain dividend announcements mention “net United Kingdom rate” of income tax payable by the company. This occurs when the company has overseas interests which incur taxation abroad, and it is a reminder of big changes in Dominion income tax relief.

From 1920 the position had been that where U.K. tax relief had been granted to a company in respect of the Dominion income tax suffered by it on its income arising in a Dominion, that company must pass on relief by deducting a correspondingly smaller rate of U.K. income tax from payments to Preference and Ordinary shareholders alike. When the standard rate of

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U.K. income tax was 10s. in the £ it was usual to encounter dividend declarations where the U.K. tax deduction as reduced by Dominion relief might be only 6s. or 7s. in the £. The net return on the investment was correspondingly expanded. A 6 per cent gross dividend less income tax at the present full standard rate of 9s. in the £ is worth only £3 6s. per cent after tax, and was worth only £3 when tax was 10s. in the £. But the same 6 per cent gross dividend, when the U.K. income tax deduction was reduced to say 6s. in the £ by Dominion relief, was worth £4 4s. net.

Such an arrangement, applied indiscriminately to Ordinary risk bearing capital, with its variable dividend rates, and also to Preference dividends which merely fulfilled a contract to pay a fixed rate per cent each year, unduly favoured Preference shareholders as against Ordinary shareholders—for the residual net profits of a given year accruing to Ordinary capital were diminished by the obligation to pay more out in net Preference dividends than would be forthcoming with deduction of income tax at the full rate. In effect Ordinary shareholders (taking into account Dominion income tax) bore the full standard rate of U.K. tax and also the Dominion tax relating to Preference dividends.

So the 1945 Act laid it down that in future Dominion tax relief should not be passed on in the old way by U.K. companies operating in the Dominions, but that instead the full U.K. income tax should be deducted from gross Preference and Ordinary dividend payments. Preference holders thus lost the favoured position they had enjoyed in the case of all that substantial group of British companies with which Dominion tax relief is a significant factor.

But the Ordinary shareholders were relieved of the inequity under which they had been labouring. True, where their dividend had been suffering U.K. income tax at, say, only 6s. in the £ the deduction became the full standard 9s., and in that respect they were put on the same footing as the general run of Ordinary shareholders. But in compensation the companies affected were generally able (given maintenance of trading results) to increase the gross Ordinary dividend correspondingly, so as to compensate for the higher tax deduction. This has occurred in such cases since the 1945 changes, and so while Preference holders, with their fixed gross rate, have had to accept a lower net dividend in such cases, Ordinary shareholders in the same type of companies, with their variable gross dividend rights, may have seen their

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gross dividend expand sufficiently to leave their net dividend unaltered.

HOW NET AND GROSS DIVIDENDS ARE AFFECTED									
				Preference dividend %	Ordinary dividend %				
					Old tax position	New tax position			
				£ s. d.	£ s. d.	£ s. d.			
Gross payment	...	...	...	6 0 0	6 0 0	7 12 9			
Net, less U.K. tax at 6s.*	...	...	...	4 4 0	4 4 0	—			
Net, less U.K. tax at 9s.†	...	...	...	3 6 0	—	4 4 0			

*Old rate, now superseded. †Current rate. ‡This is the lowest gross rate on Ordinary capital which will maintain the former net return of £4 4s. 9d.

In the example given in the table, which arbitrarily assumes a former U.K. tax rate of 6s. (actually there were very many variations in rates) we see that the effective net Preference dividend has been cut by about one-fifth. The effective net payment on the Ordinary has been maintained by raising the gross rate with the aid of benefits accruing to the equity capital under the new double taxation arrangements. In such a case directors have not uncommonly rounded off the gross Ordinary dividend on the new basis to say $7\frac{3}{4}$ per cent; but the real rise in the net dividend in such a case is, of course, negligible.

The new arrangement is important in its effect on those categories of Preference shareholders such as small investors, entitled to reclaim from the Inland Revenue the income tax deducted by the companies from their dividends. Previously (where their taxation position was appropriate) they could reclaim the whole of the tax deduction from their dividend—e.g., at 6s. in the £, or some such rate varying with their company's circumstances; and this would apply where there was no personal liability to U.K. tax.

But now they cannot claim the whole of the standard tax deduction at 9s. in the £, for another section of the 1945 Finance (No. 2) Act prevents this. That section relates to the net United Kingdom rate to whose existence we alluded earlier in this chapter; and it uncovers a very awkward little "snag" in the investment of capital in Preference shares—more especially when the investor is not liable to U.K. income tax.

In such cases the mention of net United Kingdom rate in a dividend notice or on a dividend counterfoil should be regarded as a danger signal for the very small investor. The shares receiving dividends affected by this particular taxation feature are not really suitable for him.

All that these smaller shareholders can claim for their repay-

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ment of tax deduction now is the net United Kingdom rate, which will vary from company to company, but which may easily be well under 5s. in the £ in these days, with overseas taxation rates growing heavy. There are many complications in calculating such a rate, but the broad principle is clear enough—so long as the higher rate of tax for the two countries concerned does not exceed 9s. in the £ a U.K. company would not pay more than the standard U.K. 9s. rate of income tax. If in these circumstances it has paid Dominion taxation equal to, say, 4s. in the £ on taxable profits its net U.K. rate would be 5s. That rate (i.e., 9s. minus 4s. Dominion tax) is what the company would now pay to our Inland Revenue—and shareholders will appreciate that the Inland Revenue could hardly be expected to refund a higher rate than it had received.

At the time of publishing this work considerable progress has already been made in negotiating double taxation conventions not only with our own Dominions and Colonies, but also with many foreign countries, notably the U.S.A. The double taxation conventions should in certain cases provide material advantages, often much increasing investment yields. On double taxed income there was a stringent limit to the relief that could be obtained under the old Dominion income tax relief arrangements. Such relief was confined to one half of an individual shareholder's appropriate U.K. income tax rate, or to half the Dominion rate, whichever was the lower. But now, however much tax may rise, the combined liability for tax is to be limited to the higher of the two taxes.

In the main this discussion deals with the position as affecting U.K. companies operating in the Dominions. With Dominion controlled companies whose shares are held in this country (for instance, South Africa, Australian or Canadian-domiciled companies) the mechanics of tax relief are somewhat different, but the benefits are still substantial; and if they are taken into account in the case of Canadian companies, for example, the true yield on the investment is sometimes considerably enhanced. This can be seen from the following example of a Canadian bank share, viz., Bank of Montreal shares of \$10, quoted in London at £7½, say Canadian \$30. Assuming a dividend of \$1 per share, the yield would normally be 3.33 per cent. However, when paid to a holder in the U.K. a withholding tax of 15 per cent is deducted, reducing the dividend to \$0.85. Now including this 15 per cent withholding tax the total amount of tax payable on the dividend (strictly on the profits out of which the dividend

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is paid) in Canada is at the rate of some 40 per cent, making the true gross dividend in Canada *before* deduction of tax not \$1 per share but \$1.42 per share—i.e., \$0.85 grossed up at 40 per cent. As Canadian tax is 40 per cent and U.K. tax is 45 per cent, the latter is the maximum rate chargeable on the gross dividend. In practice, therefore, a U.K. holder liable to tax at 45 per cent would have to pay only another 5 per cent in U.K. tax calculated on this notional gross dividend. Accordingly, in working out the gross yield for purposes of comparison with any other security on which tax at 45 per cent is payable, the notional dividend of \$1.42 must be used, and the gross yield to a holder paying U.K. tax at 9s. in the £ becomes 4.73 per cent. The position of U.K. holders should be slightly improved by tax changes in the 1949 Canadian Budget, so that these figures should be conservative. As always, much depends on the effective rate of tax applicable to the individual investor; and where a provisional tax relief (normally 4s. 6d. in the £) is passed on at the time of paying the dividend, the holder may have a claim to further relief. There are cases in which that relief has to be claimed from one's local Inspector of Taxes.

Distributed Profits Tax

ONE of to-day's complications in calculating the earning power on a company's capital is provided by the special distributed profits tax which Mr. Dalton decided should be levied on profits paid out as dividends (Ordinary and Preference dividends alike) as from 1st January, 1947.

The distributed profits tax is vicious in any case, for it specially singles out holders of the Ordinary capital of a company—the risk bearers—for penal treatment. Years ago Mr. Dalton himself condemned the old corporation profits tax, which had the same undesirable trait of punishing the man who puts his capital out at risk in Ordinary shares—the very man who could help to finance much needed extension of our export trade, were he given a little more incentive.

A very large proportion of retained profits is drawn off by the peculiar manner in which the tax works. With the best will in the world it is difficult for companies to retain sufficient taxed profits to provide for indispensable re-equipment. That is one reason why so many big industrial companies had to make an appearance in the capital market during 1948 and 1949 to raise new money.

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When the distributed profits tax was first introduced, it was generally appreciated that the tax would bear heavily on company profits, even though at the same time E.P.T. disappeared in respect of current financial periods. But since then the tax has been doubled with retrospective effect as from 1st January, 1947—an example of jobbing backwards in regard to taxation which itself caused a good deal of resentment and inconvenience.

Apart from the doubling of the tax its effect (at whatever rate it be applied) is least burdensome to risk-bearing shareholders in those cases where the capital is all in one class. And it is most burdensome in those cases where there is a relatively large Preference share capital ranking before relatively small Ordinary capital. This burden arises because profits tax cannot be passed on to Preference shareholders in the same way as income tax, which is deducted from the gross amount of all dividends paid, Preference or Ordinary alike (with income tax at 9s. in the £ a £10,000 gross dividend payment means that shareholders only receive £5,500).

Companies which (often owing to war conditions) found themselves after the war with several years' cumulative Preference dividend arrears to clear off have been treated with peculiar injustice by the distributed profits tax. Had they been prosperous their Preference dividends would have been paid at due dates and would not have been liable for distributed profits tax until payments began to be affected by that tax in its normal course. As it is, heavy additional tax has had to be suffered by the company (i.e., the Ordinary shareholders) just because the postponed Preference dividends have been paid in a lump sum after the new tax came into force in 1947.

Distributed profits tax at 25 per cent of the gross dividend payments (i.e., before deducting income tax) has to be found in respect of both Preference dividends and Ordinary dividends, though Debenture interest is not chargeable as part of distributed profits. On the remaining undistributed profits 10 per cent profits tax has to be paid, and the balance of undistributed profits after meeting that charge is still subject to U.K. income tax at 9s. in the £. Certain types of company, such as investment trusts, for technical reasons pay little or no profits tax, but with the normal run of industrial companies the extent to which these tax charges eat into profits reserved for re-equipment and the like is considerable. It is these savings from which, if a sound basis of operation is to be maintained, companies ought to be

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able to finance at any rate a considerable amount of their re-equipment needs.

The devastating extent to which retained profits are cut down by the present tax structure has inspired the not unreasonable suggestion that if the 25 per cent tax on distributed profits must continue, at least the Government might drop the 10 per cent levy on retained profits. But these representations produced no effect so far as the 1949-50 Budget was concerned. The conventional calculations of earnings cover for equity shares, whereby one says that XYZ Ordinary capital pays 10 per cent gross dividend and earns 32 per cent gross, commonly ignore the effect of profits tax, and thus tend to exaggerate slightly the current percentage earnings. An even more important reason for regarding the latter soberly is the fact that nowadays extra provision for depreciation of assets, owing to high replacement costs, may have to be met out of surplus profits already taxed which form part of these percentage earnings.

Profits Tax and "Ploughing Back"

By this time a good fund of experience of the working of the new tax has been accumulated, and in the great majority of cases no harm is suffered by eschewing over-meticulous earnings calculations; unless examining one of those companies with a "freak" capital structure (say a microscopic equity capital ranking after large prior charges) the average investor can safely neglect such refinements, so long as he appreciates that the slight error indicated above is there.

To show as simply as possible how distributed profits tax is working (unfortunately there are many complications in practice) let us imagine a company with a single-class capitalization of £100,000, on which it earns £10,000, or 10 per cent, before deducting any U.K. taxes. In example "A" in the accompanying table it is not paying any dividend at all, but profits tax and income tax taken together still absorb 50½ per cent of the retained profits. In example "B" the directors decided to distribute as much dividend as they could from the profits of the year, without trenching on past profits. And they find that they can only distribute £7,826 before income tax, equivalent to £4,304 after deducting both profits tax and income tax, out of every £10,000 earned before deducting distributed profits tax and also income tax at 9s. in the £; for though at first sight it would seem that £2,174 (subject to income tax) would be retained in the company,

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the fact is that distributed profits tax just about wipes out this net surplus of retained profits. Example "C", midway between the two extremes, and reasonably representative of directors' average policy in distribution of company profits, shows how things work out with half the gross earnings retained and half of them distributed.

DISPOSITION OF £10,000 SUBJECT TO PROFITS TAX

	A No dividend	B All profits distributed	C Half distributed, half retained
Profits tax	£1,000	£2,174	£1,750
Income tax	4,050	3,522	3,712
Net dividend	Nil	4,304	2,750
Net retained profit	4,950	Nil	1,788
 Total	 £10,000	 £10,000	 £10,000
 Total taxes	 £5,050	 £5,696	 £5,462
Total net profit	4,950	4,304	4,538
 Total as above	 £10,000	 £10,000	 £10,000
Effective total tax rates in the £:—			
On total gross profits	10s. 1½d.	11s. 4½d.	10s. 11d.
On retained gross profits	10s. 1½d.	20s.	12s. 10d.

Even the "fifty-fifty" distribution policy means a heavy drain on retained profits needed for re-equipment—in example "C" nearly two-thirds of the residual gross profits goes either in profits tax or in income tax; and that is with a very reasonable dividend policy in force. Gross retained profits are £5,000, and total taxes borne thereby are £3,212. A sample taken from numerous profit and loss accounts, adding up to many millions sterling, and issued in the first quarter of 1949, showed that the average proportion of taxable profits absorbed by profits tax was 16 per cent. Allowing also for income tax at 9s. in the £, this means that out of every £100 of taxable profits the average amount taken by profits tax and income tax combined might be put at something like £54. This compares with £47 15s. ruling just before the introduction of profits tax (except in those cases when E.P.T. was payable by companies).

In Chapter IV we showed how official turnover analysis details demonstrate that the average industrial manufacturing company in 1947 had £1 of profit (before taxes) left out of each £10 of gross sales, and that of each £1 of such profit the taxes took 11s., the net dividends 4s. and the net retained profits 5s.

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The last two figures are arrived at after deducting all taxation, and in view of the heavy incidence of profits tax it is of interest to examine the composition of the 11s. in the £ tax item. Grossing up the net dividends and profit retentions by the relevant rate of tax suffered (as swollen by profits tax) we can conclude that each 4s. net received by shareholders represents original gross profit of 9s. 9d.; and that each 5s. of net profits retained in the reserves of a company represents original gross profit of 10s.

Nowadays a company has to earn over £10,000 gross (before U.K. taxes) in order to provide £5,000 net addition to its reserves—and this in a post-war world where the cost of re-equipment has risen to grotesque heights, where plant costing £1,000 ten years ago, before the war, may now easily cost £3,000 or even more. And the rise in costs is only part of the story. Let investors cast their minds back to before the rearmament period when there was no profits tax, nor any National Defence Contribution (that tax which was introduced in 1937 as a comparatively modest precursor of the present profits tax, and which took 5 per cent of gross profits), and when the standard rate of income tax was 5s. in the £ or even less. Those were the days when if a company had £10,000 gross to tuck away for re-equipment it knew that income tax would only reduce the net sum to £7,500. Bearing in mind the fall in the purchasing power of the pound sterling in the last ten years, it is probably correct to say that the combined effect of taxation and high costs is to render re-equipment about three times as difficult and expensive as it was before the war. That view is expressed from the financial angle alone; physical controls on materials are another story altogether, and often a lamentable one indeed.

If plant and equipment in this country are ever to be up-to-date, is there not an overwhelming case for complete overhaul of our methods of taxing industry, and of the allowances made by the Inland Revenue to facilitate the building up of depreciation funds?

In his Budget statement in April, 1949, Sir Stafford Cripps acknowledged the strength of this case, first by doubling initial allowances for depreciation, and second by his announcement that a small independent committee would be set up to enquire into the method of computing net profits for the purpose of charging them to income tax and profits tax. Later, there was to be investigation of the larger question of the incidence of taxation in industry and its effect on risk-bearing.

As regards the doubling of initial allowances, this will be

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regarded as a palliative pending full consideration of the re-equipment and profits calculation problems. The initial allowance introduced in the Income Tax Act, 1945 was 20 per cent of the new cost of plant and machinery purchased, relief being obtained only when the new plant had been bought. As from 6th April, 1949, this allowance became 40 per cent of new cost. The immediate result of the allowance is important, for more money becomes available for re-equipment at an earlier date. But it should be appreciated that the initial allowance makes no difference to the total result in the long run, since the Chancellor pointed out that all plant and machinery receives, in wear and tear, 100 per cent of its cost over the agreed life of the plant.

CHAPTER XV

HOW THE STOCK EXCHANGE WORKS

The Stock Exchange "Zoo"—Bulls and bears—Wider meanings of such terms—Limitations of bear operations—Contango business—A day in a broker's office—Almost instant service to clients—Stock Exchange Settlement Department—The Share and Loan Department—Multifarious functions—Permission to deal—Stringent examination of new issues—Dividend announcement facilities—Certification of transfers—Future of the Stock Exchange.

Now let's pay a visit to the Stock Exchange zoo, and sort out what we really mean by the terms "bull" and "bear". (The activities of the "stag" have already been discussed in the chapter on new issues.) The bull and the bear have both an ancient and a modern significance. Most of the text-books describe a bull as an investor who "buys" stocks or shares for the purchase of which he does not possess the necessary ready money. That definition serves well enough when shares are "bought" and contangoed; when the speculator limits his outlay to that involved in paying the margin and interest to the broker or banker who finances his purchase. It may even serve when it is applied to the punter who "buys" shares on the first day of the account, without the means or the intention of taking them up as permanent or semi-permanent holdings, and with the idea that at some time during the next fourteen (or twenty-one) days he will be able to sell them again at a profit. (If the price goes against him, then at least all he is liable for is the difference between the cost and the sales price, which will be in most cases a great deal less than the commitment he would have faced had he taken up the shares outright in the first place.)

But in the modern context, "bull" means a great deal more than any of these. The word is, in fact, almost used to describe any *holder* of securities. The bull to-day is the optimist, the man who hopes and expects the securities he owns will rise in price. A permanent investor who bought Imperial Tobaccos at £4 10s. a share years ago, paid for them, and has no intention so far as he can see of ever selling them, is a "bull of Imps". The term gets nearest to its classic meaning nowadays when it is applied to the jobber who in the course of his business must become a bull of shares, shares financed on bank credit, which he has no

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intention of holding permanently, and which he has taken on his book simply to keep his business going and in the hope that a quick profit will ensue. But, by and large, "bull" to-day has a wider meaning than it used to possess; in fact, the word is on its way to becoming part of the general language. A friend of America, for example, may be described as a "bull of the States", meaning that he is optimistic for and well disposed towards the whole future of that country.

There are refinements of the word in its Stock Exchange context. A man bought Courtaulds at 56s. in 1946. He bought them as a permanent holding and paid for them with his own money. His friends will say of him that "He is a bull of Courtaulds at 56s.", the implication being in such a case that the price has come down substantially since his purchase. (By July, 1949, Courtaulds were around 34s.) Some of his friends may also say he is a "stale bull". This may or may not be true. The phrase means that the investor bought shares at 56s., hoping for appreciation. This having failed to materialize, the investor's friends, in calling him a "stale bull", imply that the investor is now merely waiting for the shares to recover to his purchase price, or perhaps a little above it, before selling. Thus, people will sometimes damn a share with faint praise, saying "There are too many 'stale bulls' of XYZ about"—which means there will be plenty of sellers on any rise.

Much of the above, stood on its head, applies to bears. In the word's original sense, a bear was a man who sold shares he didn't possess in the hope of buying them back more cheaply later on and thus making a profit. Probably he took only a short view in doing so. But under the contango system (of which more later) he may be a bear for months on end, postponing delivery each Account, and generally being paid interest for putting forward the date on which he was entitled to payment. Even without contangoes, it is still possible for a speculator to sell shares he doesn't own on early days of the Account, hoping to buy them back more cheaply before the Account closes.

As with the word "bull", however, the word "bear" to-day has a wide and general application, being used to describe the pessimist, a man who thinks share prices are too high. Oddly enough, many people who see nothing wrong in bull purchases—buying shares which one possibly cannot afford and which one has no intention of holding permanently—regard bear operations as morally wrong and anti-social. Since the vast majority of people interested in Stock Exchange matters *own* securities and

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are, in consequence, natural bulls, wanting prices to rise, it may be understandable that nearly everyone regards the bear with disfavour. But he is no more immoral or anti-social than the bull. He may check a runaway rise by selling and steady the market on a fall by his covering purchase, just as a bull may rally a market by buying at the bottom and check a rise by subsequently taking his profits.

The bear, of course, suffers from an inherent disadvantage, in theory at least, because his possible profits are limited by the fact that (except in "freak" cases of partly paid shares irrelevant to this argument) a share cannot fall to less than nothing, whereas a share may rise to any figure. (If a share is sold at £1 and becomes completely valueless, the bear can make a profit of no more than 20s. per share. But if a share is bought at £1, then clearly the sky may be the limit to its rise.)

Operating the Contango System

FOR nearly ten years from the outbreak of war in the autumn of 1939 the odd phrases "contango", "backwardation", "taking in" and "giving on" almost passed out of the Stock Exchange vocabulary. When the Stock Exchange Council decided late in April, 1949, to sanction a modified resumption of the contango system (jobbers being the main advocates of resumption) some of the younger members of the "House" were at first unfamiliar with the procedure and rather baffled by its intricacies. But that the reform will ultimately prove its worth is highly probable. With cash dealings there is a tendency for fluctuations in prices to run to extremes. They are moderated by the contango system, the effect of which is to provide facilities for postponing payment for a purchase of stock (a bull transaction) from the account day when payment would normally be due to some later date—or, on the other hand, for similarly postponing delivery of stock which has been sold in a bear transaction. It may be said that every bull (since he must sell some day unless he becomes a permanent* investor in the relevant share) is a potential seller. Contrariwise every bear must reckon with having to deliver the stock some day, and so is a potential buyer.

It is one of the useful by-products of the contango system that the publication at the end of every account of contango rates gives a good idea of the market position for the time being in individual active shares—i.e., whether bulls or bears predominate in the speculative commitments outstanding in a leading issue.

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When bulls do predominate, and when they wish to carry over their purchases to a later account instead of taking them up and paying for them at the end of the Stock Exchange account, they will be charged a "contango"—that is, interest on the cost of carrying the shares until the end of the next account; and this process can be repeated in following accounts. Continuation charges (the alternative, more dignified official name for contangoes) could run on for some months before the effective cost to the client would be as much as the 2 per cent stamp duty payable on transfers when a purchaser is actually taking up stock.

For example, in the first account after contango business was restarted the rate at which prominent South African gold shares were continued was of the order of $4\frac{1}{2}$ per cent to $5\frac{1}{2}$ per cent per annum on the purchase price, representing a much smaller sum for a few Stock Exchange account periods. On some leading industrials the contango rate was lower—3 per cent to 4 per cent. But in some industrial shares so large a bear position was disclosed that the contango charge was non-existent—"evens"—and in some stores shares where bears especially prevailed it was they who had to pay a charge instead of receiving it from the bulls. Let us explain.

Normally, assuming a predominantly bull position, the bulls will be paying contango money and the bears will be receiving it. In Stock Exchange parlance, the bulls will be "giving on" the shares and the bears will be "taking in". But it may occasionally happen that the bears do not receive contango money, but instead, in the course of continuing their bargains, have to pay a charge, under the uncouth name of a "backwardation". This is what happens when the bear account in a certain share is extremely heavy, resulting in a shortage of shares. Then the backwardation is the percentage paid by bears for the privilege of postponing delivery. When there are thus lots of potential buyers (i.e., bears) about, and the market is revealed as short of stock in this way, the technical position in the shares is strong.

A contango or continuation transaction really comprises twin bargains—i.e., the commitment is closed for the old account and also reopened for the new account. These transactions are carried out at the price ruling at the close of business on the day before contango day, which is the first day of the Stock Exchange settlement period, the latter stretching over five days in all. For a selection of leading shares a special making-up price list is published which governs contango transactions. Shares not in

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the list (assuming contango facilities are available for them) will be dealt with at the existing market price.

The 1949 restoration of contango facilities was intended primarily to broaden Stock Exchange business by providing technical assistance for jobbers in the market; but (so long as brokers are willing) it should also help the short-term buyers among the public to deal more cheaply, partly by reason of the saving of stamp duty already indicated, but also because contangoes can contribute to more efficient working of the jobbing system, to increased turnover and consequently to closer prices.

Critics of the contango system are not lacking within the "House" itself. They fear that it might lead to over-speculation in good times. This objection is partly met by certain modifications in the post-war resumption arrangements as compared with pre-war practice, and especially by the Stock Exchange Council's decision that the commitments arising from contango facilities shall be reviewed every six months, though some observers regret that there is to be no publication of the position disclosed by such reviews.

Clients who wish to carry over securities must take care to notify their brokers early on the morning of the contango day, the first day of the Stock Exchange settlement period. By no means all brokers, however, are willing to accord such facilities.

A Broker's Duties

HAVING described the leading local fauna, let us see what a day in a stockbroker's office is like. Contrary to the popular belief that stockbrokers and their clerks do not commence work until some time after ten a.m., and leave for home soon after lunch, it is quite usual for the first clerks to arrive at the office by nine a.m., and by nine-thirty the day's work is in full swing. The previous day's business has to be posted in the clients' ledgers, price lists have to be ready for the opening quotations, the morning's post has to be opened and sorted and passed to the departments concerned. Orders and enquiries will be handed to the partners of the firm, the first of whom is usually at his desk by nine-thirty, having absorbed the news in the financial papers at breakfast and in the train. He will hand over the enquiries to the statistician for his expert comment, after giving any necessary lead, and will note the orders for dealing. If he does not attend to these personally he will pass them on to his authorized dealer.

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As the "House" opens its doors punctually at nine-thirty, the "Blue Buttons" or unauthorized clerks (whose badge is a blue button in the coat lapel) will be waiting to go round the markets in order to get opening prices. These may vary little from the previous night's close, but often news of importance will have caused a change in at least one or more sections. Soon after ten o'clock the Blue Buttons will be in communication with their office, reeling off lists of prices in a jargon familiar only to those long associated with the Stock Exchange. All price changes will be recorded by a clerk in the brokers' dealing room, which is a room set aside for this purpose and for the handling of orders.

Having noted any alterations, the clerk will then take the price lists into the partners, usually giving a short report which might run as follows: "Gilts—no change, Banks—firm, Industrials—better in places, Woolworths—9d. up, Imps—1-16 better, Oils—easier for choice, Mines—firm, Rubbers—flat." This general outline tells the busy broker the pulse of the market and enables him to pass on the information to his clients, many of whom are already 'phoning him for advice, and to maintain his intimate contacts with the Associated Stock Exchanges and other provincial centres. By eleven o'clock the first transactions will have been completed and price changes will be coming through every few minutes.

While partners, dealers and "Blue Buttons" are engaged in executing the day's orders, "Red Buttons", or settling room clerks, will be checking the previous day's business in the room situated immediately below the floor of the "House", and the office clerks will be handling the hundred and one other jobs attached to completing transactions started possibly weeks before; preparing transfer deeds, delivering stock to buying brokers, paying for stock delivered by selling brokers, registering transfers with companies, collecting certificates, claiming and paying dividends, etc., etc. Typists will be dealing with correspondence, while the telephone operator handles myriad calls.

To the uninitiated, it is often a source of wonder that a broker can supply the "touch" in any particular share almost at a moment's notice. It should be appreciated that a continuing and intimate contact with the markets so impresses share quotations on the broker's mind that he can memorize literally hundreds of prices. If by any chance the price required is of a share not frequently dealt in, then it is possible for him to get into contact with one of his "House clerks" in a very few minutes.

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This is made possible by the private telephone system operated in the Stock Exchange, which connects subscribers to a number of telephone boxes adjoining the floor of the "House". Installed and maintained by the G.P.O., and operated by the Exchange Telegraph Co., this exchange is entirely self-contained and has no connection with the outside system. It enables the broker to contact his dealer on the floor of the "House" with the minimum of delay, while the dealer can report to his office in a matter of seconds.

Thus is the broker able to give almost instant service to his clients. Quite often the client can be asked to hold the line while, via the other 'phone, the broker gets in touch with his dealer, enabling a deal to be completed within a matter of minutes. In addition to the price service given by the "Blue Buttons", most brokers' offices are fitted with the tape machine, which all day long is ticking out its news.

From the time the first bargains are reported by the dealers and are booked by the dealing room clerk, the contract department gets busy. Within a short time contract notes will be ready for signature by partners. No matter how many orders may be executed, it is rare for the dispatch of contract notes to be delayed until the next day. In boom times, partners and staff are working at high pressure—sometimes the office staff will work on Saturdays, even though the "House" itself is, of course, closed that day—and although the hours worked may not appear long, the speed at which business is transacted is very exhausting mentally.

The Settlement Department

THE Council of the London Stock Exchange compels firms to become members of the Settlement Department (i.e., to participate in the clearing) if and when they deal in the securities in the clearing list. The latter now includes slightly less than two hundred securities; before the war it was much more comprehensive, covering three hundred and forty securities, and it is planned gradually to extend it as the fortnightly account system gets under way. The reason for compulsion will become plain later on, but first of all we should follow a simple bargain during the course of an account.

Broker A receives an order to sell, say, 1,000 shares. For the purposes of our argument let us assume that he sells the entire holding to B, who sells to C, C then selling to D. Of these four

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parties, A and D alone retain their interest on behalf of their clients; the only interest that B and C have is in receiving or paying differences between the purchasing and selling prices. Much time could be saved if A is put into touch with D without going through B and C, and this the Settlement Department does in a speedy manner. In an isolated instance the time so saved would be negligible, but when the security involved is an active one, and a particular line changes hands many times during the account, the sum total of time saved is enormous.

So far only a simple bargain has been followed. In reality, however, the set-up is much more complex. There are 610 firms of brokers or jobbers, and during a typical Account 78,000 bargains were marked in the 190 securities which at the time comprised the settlement list. Moreover, it is very unlikely, even where only four firms are interested, as in our simplified example, that the bargains would be of the same size, namely, 1,000 shares. Any deviation from this convenient assumption adds to the difficulties involved. It will suffice here to say that the reason why investors are sometimes confronted with a number of transfers to sign when purchasing or selling is that the bargains done have not "fitted".

The business of putting ultimate buyers and sellers into touch and eliminating intermediaries rests on the compilation by all firms concerned of a list of bargains for each of the clearing securities. The list is divided into two parts, one for sold bargains and the other for bought bargains. The names of the other party to the bargain must be recorded, so that if X says he sold 1,000 Bats to Y, this bargain will feature on X's Bats list as a sell and on Y's Bats list as a buy. Thus, it is possible at the commencement of the settlement to agree lists one with the other. Where discrepancies arise, the bargains in dispute are deleted or adjusted. After checking has been completed, "traces" are made up, trying to get as near as circumstances permit to the simplicity of our example, and avoiding excessive splitting of holdings. The department receives tickets from the buyer, and noting¹ the name of the deliverer, or seller, on the back, puts them in his box in the settling or checking room. (The latter is separate and distinct from the Settlement Department.) It will now be clear why all firms must participate; were even one allowed to remain outside, there could be a break in the continuity in the trace; the participants would be much inconvenienced, and the function of the Settlement Department would be impaired.

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Charges are apportioned to the number of bargains cleared for each firm. In a busy time, the cost per bargain is low because the overheads can be spread over a large number of bargains and the actual running costs are comparatively light; at such a time, the savings in messengers' and clerks' time more than offset this charge, and investors have their bargains completed in much shorter time than would otherwise be possible. In slacker times, the cost per bargain rises because of the incidence of the overheads, and since messengers and clerks have less to do, there is less need to save their time. This double effect usually leads during slack periods to a demand for the closing of the department, but the work in busy times has so far prevented that from happening. In 1948, when business had declined after the post-war boom, the Council agreed to forgo the rent of the premises and, in addition, to contribute a substantial sum to upkeep. Thus ended the department's policy of being self-supporting which had been followed since the days when it was founded under private ownership.

From our description it will be seen that the actual settlement (which takes place in offices above the Stock Exchange) demands a high degree of discrimination and personal judgment. It is for this reason that the human element is so strong here, and that so far no mechanical means have been found to satisfy the needs of the department. The personnel consists of full-time officials, supplemented during the busy part of the account by part-time staffs recruited from various sources, chiefly the financial institutions which surround Throgmorton Street. Before the war the staff, temporary and permanent, worked to the small hours of the morning at least once in an account, and in time of great activity a second late sitting was necessary. Owing to catering and accommodation difficulties, work now ceases each night in time for all to catch the last train home, and the operation is spread over three nights.

On 3rd August, 1948, a useful addition to Stock Exchange facilities was inaugurated in the shape of the Centralized Delivery Department. Designed to speed up transactions and save manpower, this department occupies a self-contained part of the Settling Room. It is intended to replace the old system of delivering transfer deeds to the numerous offices of buying brokers, and of collecting cheques later. The scheme does not deal with bearer securities; nor, in its initial form at any rate, did it cover gilt-edged securities dealt in for cash.

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The "Share and Loan"

THE Council of the Stock Exchange is a body of unpaid representatives of members elected by their fellows to act in much the same way as directors of companies do. As in other cases of elected legislators, the Council needs a staff of permanent officials who execute the decisions of the governing body and carry out routine duties. And the multifarious and important functions carried out by the Stock Exchange Share and Loan Department justify detailed treatment in this instance.

Some of the Share and Loan offices deal almost exclusively with members of the Stock Exchange, others deal largely with members' staffs, while other offices are concerned with company executives and the general public. The Department is old-established and has had many statistically-minded Secretaries. Mihill Slaughter, who edited the *Railway Intelligence* in the 1860's, and Sir Henry Burdett, the first editor of *Burdett's Official Intelligence*, now known as the *Stock Exchange Official Year Book*, were two such men. Others who have had great ability in other directions were J. A. Torrens-Johnson, R. E. Satterthwaite, and the present holder of the office, Mr. A. F. B. Cooke, a barrister of Gray's Inn.

The offices which comprise the Department are the Secretary's office, the quotations and permission to deal office, the general office, the certification office, and the reference library. The Secretary is also editor of the *Stock Exchange Official Year Book* and the *Stock Exchange Weekly Official Intelligence*, and to that extent the editorial offices of those publications come within the jurisdiction of the Share and Loan Department, which is housed in 26, Austin Friars, E.C., opposite the site of the bomb-destroyed Dutch Church. The building, itself reminiscent of Dutch architecture, was erected in 1899. Owned by the Stock Exchange, it is shared with member firms (though these tenancies are diminishing as the Department grows) and with the Stamp Office of the Inland Revenue. This joint tenancy leads to the common belief that the Stamp Office is part of the Share and Loan; possibly the air of officialdom common to both is also a contributing cause to the misunderstanding. Share and Loan officials are to be seen denying, wistfully it may seem, any kinship with an office into which pour great sums of money destined for Chancellors of the Exchequer—some of whom express their gratitude in peculiar ways. It is believed that the Civil Servants also make it plain that they have no connection

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with the department upstairs, though personal relationships are very friendly.

The work of the quotations and permission to deal office is largely concerned with getting all the necessary documents in order for presentation to the Quotations Committee. This is not to say that the office is concerned mainly with routine matters; sponsors of offers for sale and placings are continually encountering new difficulties, and these have to be presented for decision. The number of applications which are turned down by the Committee is quite small, and this is due to two factors. First, Stock Exchange members who support the company's application may be unofficially informed that leave to deal is unlikely. The company, of course, has the right to proceed with its application, but most take the hint and avoid the publicity which follows a refusal. Secondly, others who would like the facilities but who believe that these will be denied are kept away by the knowledge of the stringent examination which awaits them—a scrutiny which has become increasingly drastic in recent years. When an application has been refused, no reason is vouchsafed, for undue publicity can destroy any defence against an action for libel or slander. There are very few cases when facilities have been withdrawn after having been granted. The wide powers involved are wielded not so much for the benefit of Stock Exchange members as for the general public's welfare; and in this matter the Stock Exchange authorities are constantly moving ahead of legal requirements.

The grant of trading facilities, of course, implies no guarantee whatever by the Council. This body is in no position to judge the technical merits of industrial processes nor the probable demand by the public for the products of the company. Nor should it attempt to do so. It is solely concerned with giving the potential investor as much information as possible in order that he can form a fair judgment for himself. Because of its Records Office, the Council is usually in a position to know of any sinister implications associated with the names of certain promoters and directors; implications which could be missed by the investor and even by his advisers.

It remains to consider the functions of the general and certification offices of the Share and Loan Department. These offices are concerned with services to members after the application for trading facilities has been granted. The phrase "general office" is a rather misleading title for the office it describes, for although this office deals with queries in general,

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it is almost exclusively concerned with the announcement of dividends and the subsequent marking of securities *ex dividend* in accordance with the Rules of the Stock Exchange. At the time trading facilities are granted companies are required to give an undertaking to inform the Department, usually by letter, of the amount of any dividend as soon as it has been recommended or authorized by the board. In the case of a final dividend, the net profit figure for the year (even if subject to audit) and the net profit figures for the previous year are also required to be forwarded.

So soon as this information is received, it is posted up in the House in order to assist the maintenance of a true market price: to this end there are special arrangements for making known dividend announcements received during market hours. These are first of all transmitted by a "flash" message on the Translux, which exhibits the message by passing large letters across the three illuminated screens placed in convenient positions in the House. Then a longer message is sent over by telewriter, and finally the official announcement is posted on one of the House notice-boards. Periodically, a list of securities being made *ex dividend* and the date from which dealings in this form are to take place is prepared, printed and posted. In addition, this office is also concerned with "rights", valuations of foreign dividends and similar matters.

Certification by the Share and Loan Department was extended in the early 1930's, and the office on occasions is now one of the busiest. Its function is to speed up transfers as they move from the selling broker to the buyer. Where a seller has sold all the holding comprised in a certificate to one person, this being known as a "fit", the transfer and the relevant certificate or certificates are simply handed over to the buyer for eventual dispatch to the company after signature. But if the holding is to be divided among two or more buyers, or if the holder sells only part of his holding, desiring to retain the balance, the certificate is needed by at least two people in order to prove title. The certification office acts as an intermediary for these parties.

The transfers, with the relevant certificate or certificates and instruction sheets, are lodged with the certification office. After examination to ascertain that the transfers and certificates are in apparent order, the transfer deeds are stamped to the effect that a certificate covering the transaction embodied in the deed has been forwarded to the company. Deeds bearing the Share and Loan stamp must be accepted as a good delivery, so that in

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a short space of time, usually less than an hour, the depositing broker receives his deeds back and, in effect, the equivalent of his portion of the certificate. This method effects a considerable saving of time, and although 1s. per instruction sheet is charged brokers find it financially advantageous as well as convenient to use the services offered. At the end of the day the certificates are forwarded to the company by registered post, with a copy of the brokers' instructions. The company then awaits the receipt of a transfer of so many shares (or so much stock) out of the name of A into the name of B, according to the instructions.

It is not necessary to use the whole of the security comprised in the certificate. Occasions may arise when the market could not absorb the whole amount without seriously affecting the price, or it may be that the name of one of the purchasers is not immediately available. The certificate is then deposited, with instructions and transfers for part of the holding, leaving the balance "name shortly". This balance is held by the company to the order of the Share and Loan Department, which transmits instructions regarding such balance from the depositing broker.

It must not be thought that the Share and Loan Department is the only agency which can give an official certification. Stock Exchanges affiliated to the Council of Associated Stock Exchanges provide a similar service, and company officials, of course, certify transfers on behalf of their companies.

Future of the Stock Exchange

Two or three years after the end of the war a reduction in the volume of business gave rise to questionings as to the future of the Stock Exchange, especially as it seemed likely that an increasing proportion of the diminished turnover would be represented by the least remunerative class of transactions. The quantum of medium-sized business is tending to diminish, squeezed between the inroads on middle-class earnings made by post-war taxation on the one hand and the high cost of Stock Exchange transactions on the other. The latter results largely from the doubling of Government stamp duties in a post-war Budget. Business on behalf of such institutional investors as insurance companies tends to expand, though it is handled by a relatively small number of Stock Exchange firms. Since small savers effect part of their saving through payment of premiums on life assurance policies, such expansion may be a symptom of the planned redistribution of incomes which has been accelerated since the end of the war.

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The small investor may have to be relied on for an increasing proportion of business, and if so measures must be devised to cater for his requirements in the matter of direct Stock Exchange investments. So far the Stock Exchange authorities have been rather lukewarm in this respect (reflecting the attitude of many members) while at the time of writing the Government's inclination seems to be rather towards compulsory saving on a national basis by means of a Budget surplus, than towards encouraging small investors to secure an individual stake in industry. And Stock Exchange securities have to compete with the attractive yields and security offered to the small man by Savings Certificates and building society investments. The facilities offered by these channels of investment are advertised widely, and generally with skill; but the London Stock Exchange has been reluctant to go beyond a most modest and formal intimation of the mere existence of this great institution. This policy must change if the small investor is to be catered for adequately. And dignified "prestige" advertising might also do much to dispel the odd notions as to the functions of a Stock Exchange which sometimes prevail, even in otherwise enlightened quarters.

Domestically, the Stock Exchange has recently had to take various financial measures to cope with the rising costs of running the Stock Exchange itself and the Share and Loan Department, such as a substantial increase in members' entrance fees as from 1st May, 1949, and the decision to make a charge for granting quotations to new capital issues. This latter step, unprecedented in London, had been taken long ago in some other centres. Its effect on the individual investor will be imperceptible, and it will mean only a minor addition to the cost of company flotations; but it will provide a substantial supplement to annual Stock Exchange revenues.

That Stock Exchange members are perhaps sometimes ahead of their Council in assessing public reactions was suggested by the strong internal opposition to a proposal launched during 1948 that commissions should no longer be shared with the banks and certain other agencies which introduce business. The proposed new rules were rescinded, and a new line of approach to the question of commissions may be initiated. The scale of commissions might be remodelled to remove anomalies, while the formation of Stock Exchange firms into larger units might help to reduce expenses; a tendency towards mergers is already noteworthy.

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Some measure of restoration of "free closing" (discussed in the next chapter) has been effected, and this may help speculative business a little. The partial restoration of contango facilities will also be useful. Some firms have been impelled by the restrictions on United Kingdom investments to build up a promising business in South African and Australian securities.

In so far as jobbers especially are concerned, high taxation has made heavy inroads into the capital they require to maintain their "books"—adequate stocks of the securities in which they deal. A representative figure for working capital might be £50,000 per firm, and this will have to be painfully accumulated by the individual partners in many cases. Shortage of working capital is one reason for restricted dealing facilities, and it may be that some new form of organization, involving the introduction of capital from outside the "House", will have to be considered. The methods adopted by Lloyds' underwriters in the insurance world have been instanced as a possible source of inspiration.

As an international market in stocks, London has been hampered by the need for maintaining strict control over foreign exchange transactions since the war ended. With the position aggravated by our high stamp duties, it is claimed that the controls on switching of non-resident-owned sterling securities have shifted the international market in a security such as Shells to New York rather than London. (Switching is selling one security and buying another, usually of the same type.) During the latter half of 1948 there was virtually a ban on non-resident switching. Then the restrictions were relaxed somewhat, but they are still harmful to business, and until they can be reduced further, and until some steps can be taken to cheapen the cost of Stock Exchange transactions in London, our market in international securities is likely to be a shadow of its former self.

CHAPTER XVI

BUYING AND SELLING SHARES

Short guide to Stock Exchange procedure—Purchase of shares—How brokers bargain—Details of contract notes—"Cum div" and "ex div"—Passing the name—Dividend requests—Completing transfer deeds—Registration procedure—How sales are effected—"Splits"—Limits—Marking the bargain—The scale of commissions—Concessions in commissions—Details of stamp duties and fees.

To the uninitiated, the mysteries of the Stock Exchange may prove a deterrent to investment of their money through that institution. This is largely the result of the strictly enforced rule which prohibits a stockbroker from advertising, and it is the object of this chapter to explain how a bargain is "done", by following a transaction through all the intricacies of the Stock Exchange machine.

The prospective investor who is unable to judge an investment for himself should take steps to get the advice of a stockbroker, or, failing that, a banker or solicitor (or even a financial newspaper!) with a view to getting expert advice on the type of investment most suitable to his requirements. If the services of a banker or solicitor are used for the purpose of making a purchase or sale of shares, the order has ultimately to pass through the hands of a member of the London or one of the provincial Stock Exchanges, so that the use of a broker direct saves a good deal of time. Investors not in touch with a firm of brokers may obtain details of brokers willing to act, on application to the London Stock Exchange.

On receipt of an order to buy shares, either direct or through a bank or other agent, the stockbroker enters the market, where he approaches the jobber—the wholesaler who keeps a "book", i.e., buys or sells the particular share in which the broker wishes to deal. Without disclosing whether he is a buyer or a seller, the broker asks the price of the share concerned, and in reply receives two prices, one at which the jobber is prepared to buy (the lower) and one at which he is ready to sell (the higher). The difference between the two prices represents the jobber's "turn"—that is his profit (assuming that he can later "undo" the bargain on this basis). The broker, in this instance a buyer, might take note

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of the higher price mentioned and if, after trying other jobbers in that market, he failed to get the shares offered at a lower figure, he would buy the required number of shares from the first jobber (if that individual was still willing to deal) and report the transaction to his office. This question of knowing whether and when to deal before going to test the price with other jobbers is a tricky business. It may be better to deal with the first jobber. Or the jobbers subsequently approached may quote a keener price. If they don't, the first jobber may not be willing still to make his original price. (He may have sold all his "cheap" shares.) The broker who always knows when to strike a bargain to his client's best advantage is a pearl beyond price!

The institution of jobbers, peculiar to the London Stock Exchange, undoubtedly helped London to maintain an exceptionally free market for many years. Such maintenance was much easier before the war, when more complete contango and option facilities provided jobbers with the means of "hedging" (protecting their commitments) and so supplied a shock absorber for market booms and market slumps alike. High taxation, too, has tended to reduce the jobber's working capital, and consequently the amount of stock he can keep on his book. Indeed, since the war there have been times when it has been very difficult to keep the jobbing system functioning smoothly. There are knowledgeable people who would like to see the Stock Exchange Council press for restoration of full pre-war facilities—as much in the national interest as for any other reason.

On receipt of the details of the order, the broker's clerk takes steps to prepare a contract note, which usually consists of a form on which is printed the name and address, etc., of the firm of stockbrokers handling the transaction. It also bears the printed words "Bought for and on account of.....for settlement....." The preparation of a contract note consists of calculating the cost of purchasing the shares, to which are added the various charges incurred by the purchaser. In the case of a purchase of stock or shares in a company, a charge has to be made of 2 per cent for Government *ad valorem* stamp duty. In the case of British Government stocks, Colonial or Indian Government stocks, and bearer bonds, the transaction will be free of this charge. In addition, where investment in a company's securities is involved, the purchaser is liable to pay a fee of 2s. 6d., the amount charged by most companies for the registration of a transfer deed.

Next comes the broker's commission, which is calculated on a

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sliding scale of minimum commissions laid down and strictly enforced by the Council of the Stock Exchange. This scale is detailed later in this chapter. Except in the case of very low-priced shares a broker's charge is usually less than the amount mulcted by the Government. The final charge which will be entered on the contract note is that of the contract stamp, which every note must bear. This is a trifling sum and is roughly 2s. per £500 of consideration money.

"Cum" and "Ex" Dividend

THE contract note having been prepared is dispatched to the investor, and entitles him to any dividends, rights, bonus shares, etc., which may become payable after the date of purchase, always providing that at that date the shares are not quoted *ex dividend*, *ex rights*, etc. The shares must be "*cum*" (or "*with*") dividend, rights or bonus as the case may be, on the date of purchase if the purchaser is to receive these things.

To make the position clear we will assume that a dividend of 5 per cent is declared by a company on a Tuesday, and that the £1 shares of this company are quoted at 25s. middle. On the announcement of the dividend, and assuming the declaration makes no alteration to the price of the shares, the price will be supplemented by the words "*cum dividend*". Dealings will continue on this basis, i.e., 25s. *cum dividend* until it is decided to quote an "*ex dividend*" ("*without*" dividend) price. On that day (which, with the exception of gilt-edged stocks is the first day of the new account) the shares will be quoted 24s. 6d. "*ex*" dividend. From this it will be noted that the approximate net value of the dividend has been deducted from the "*cum*" dividend price, the sum deducted being calculated by taking the gross amount of the dividend, i.e., 5 per cent or 1s. per share and deducting tax at 9s. in the £ or roughly half. Thus there is little advantage to the investor in buying *cum dividend* if he is paying tax at 9s. or more on his income. If he is a sur-tax payer it pays him to buy "*ex*", for he saves more by way of reduction in his purchase price than he would receive by way of net dividend; but if he pays little in the way of tax he will gain by buying "*cum*", for the dividend will be worth more to him than the "*dividend deduction*" in the market price when the share goes "*ex*".

If the shares are purchased "*cum*" dividend the investor will in due course receive the dividend from the company, but should

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the transfer deed not have been registered by the time the company closes its books for the preparation of dividend cheques the stockbroker will take steps to claim the dividend from the seller, who is not entitled to this dividend which he will in due course receive direct from the company. The same procedure is followed in the case of a declaration of rights, bonuses, etc. In the case of Government stocks it is usual to quote the securities ex-dividend when the books of the Bank of England are closed for the making up of accounts. Owing to the work involved this may take place as long as six weeks before the actual date of payment.

Having made his purchase the investor should note the date on which he is to pay for his shares, and if he has not already done so should take steps to let his broker know the full name and address in which he requires the shares to be registered. To minimize correspondence, it is advisable for the investor to give his broker these details when placing his order to purchase, supplementing the name and address with his occupation. If the purchaser is a man it is sufficient to state: Doctor, Grocer, Clerk, Chemist, Retired, etc., as the case may be, but should the investor be a woman it is necessary to state if she is a spinster or a widow, and, if married, to give her husband's full name.

Having received full particulars for registration, the stockbroker prepares a name "ticket"; this will state the number and name of the shares purchased and the price, followed by the full details of the name and address of the purchaser. At the appropriate time it will be handed to the jobber from whom the shares were purchased. The jobber in turn will pass the ticket on to the stockbroker from whom he purchased the shares. On receipt of the ticket, the selling broker will prepare a transfer deed transferring the shares from the name of his client (the seller) into the name on the ticket, and will have it stamped with the requisite stamp duty of £2 per cent of consideration money.

The transfer will then be forwarded to the seller for his signature, and on return the ticket is pinned to it and the whole will then be delivered direct to the buying broker, who will pay the cost of the shares, plus the amount of *ad valorem* stamp duty. After checking by the buying broker to see that the deed is prepared correctly, it is then despatched to the purchaser for his signature, usually accompanied by a dividend request form, and if the broker knows that he cannot register the transfer in time for a recently declared dividend to be sent to the purchaser direct from the company, he will enclose a cheque and income

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tax voucher for the dividend deducted when the shares were paid for.

When uncertain of a client's requirements, it is usual for a broker to attach a dividend request form to the transfer deed before dispatch to the investor. This form need only be completed when it is desired to instruct the company to forward future dividends to another person or to a bank.

The transfer deed is quite a simple document, merely stating that the seller (full name and address heads the form) in consideration of a sum (the amount is the cost of the shares as paid by the purchaser) transfers to (name and address of purchaser) so many of such and such shares. The deed will have been signed by the seller and attested by an independent witness, and only one witness is required. So many mistakes are made in this simple operation (even by seasoned investors) that the attestation and signature clause is set out hereunder:—

Signed, sealed, and delivered by the above-named	
(Full name of buyer or seller)	
Witness {	Space in which buyer or seller should sign. SEAL.
in the presence of	
Signature of witness	
Address of witness	
Occupation of witness	

It is necessary that the witness should state his occupation and, if a woman, whether she is a married woman, widow, or spinster; and, if married, she should give her husband's full name.

A wife may not witness the signature of her husband nor a husband the signature of his wife.

When a transfer is executed out of Great Britain it is recommended that the signatures be attested by H.M. Consul or Vice-Consul, a clergyman, magistrate, notary public, or some other person holding a public position—as most companies refuse to recognize signatures not so attested. The date must be inserted in words and not in figures.

It very often happens that the buying broker's ticket has been split into two or more "split tickets" in order to satisfy the requirements of two or more sellers of the shares. For example, a purchase of 100 shares may result in the delivery of three transfers for, say, 50, 30 and 20 shares from three different

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sellers. Each transfer should be signed and witnessed, as explained above, and returned to the broker for his attention.

Registering the Transfer

ON receipt of the signed transfer from his client, the broker will take steps to register the deed at the office of the company to whose shares the transfer relates. If a dividend request form has been completed, the broker will at the same time advise the person or bank concerned that dividends on so and so shares may be expected on the due dates; and in the case of a bank he will indicate the account to be credited when received.

The registration of a transfer deed usually necessitates the payment of a registration fee. (This charge will have been stated on the contract note.) The registration of transfers in Government, corporation, or colonial government stocks is usually free of this charge, but the majority of public companies charge a fee of 2s. 6d. per deed. It is as well to make it clear that although the investor's purchase may have resulted in the delivery of several transfers, he is liable to one fee only; any further expense incurred in this direction is the liability of the jobber who split the broker's name ticket.

On registration of the transfer, the company will issue a receipt acknowledging the fact that the deed has been lodged with it for registration and that the appropriate fees have been paid thereon; it will also state a date when the certificate will be ready for collection. The period between registration of transfer and collection of certificates varies considerably, but usually runs from three to six weeks. If considerable activity has taken place in the company's shares, the staff may be overwhelmed and the delay may be greater.

The broker's final check, before filing away the receipt pending collection of the certificate, is to see that the transfer has been registered before the company concerned closes its books for the preparation of dividend cheques. Should he find that the deed was not registered in time, he will claim the dividend from the seller on behalf of his client and will forward this on or soon after the date of payment. When the certificate is collected from the company's office, it is checked to see that it is correctly prepared and then forwarded to the investor or his bank as desired.

The procedure in an order to sell shares is the same as with a purchase, except that it is advisable to forward the relative certificate with the order to the broker; this obviates any mistake

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occurring in transmission. On receipt of the order to sell, the broker follows the same procedure as in the case of a purchase, but he now seeks the best bid price offered for the shares.

The sale having been made, a contract note is sent to the seller stating that so many shares have been sold at a certain price on account of the seller, for settlement on a certain date. The contract note differs from a bought note inasmuch as there are no charges for stamp duty or registration fee. Only the broker's commission and the contract stamp are deducted from the gross proceeds of sale to show the net amount to which the seller is entitled. There is one exception to this rule, and that is when a small number of shares or amount of stock is sold "free". In effect this means that, owing to the small sum of money involved and the small number of shares, for which the jobber may not have a buyer, he may find it necessary to register the shares in his own name and in so doing incur a charge for stamp and fee that would run away with the small profit he would normally make. In this event, the broker will deduct the stamp and fee, in addition to his commission and contract stamp, from the gross proceeds of sale.

As in the case of a purchase, the shares dealt in are considered to be *cum dividend* unless specifically stated otherwise, and if the seller receives a dividend after he has sold the shares "*cum*" he should send it to his broker for handing on to the purchaser. In the same way, the seller is not entitled to any rights, bonuses, etc., which may be declared after he has sold his shares.

On receipt of the "sold" contract note, the seller will note the date of settlement, which is the day when the broker will dispatch a cheque for the proceeds. Just prior to this date the seller may expect one or more transfers for signature, and these should be returned promptly.

The seller may be surprised to find that his sale of shares has resulted in several transfers being sent to him for his signature. This is very often the case, particularly if the number of shares sold is large, and the number of transfers is explained by the fact that the shares have been purchased by several different buyers. As is the case with bought transfers, the seller does not incur any additional liability for stamps or fees, any loss resulting on splitting being borne by the jobber.

The transfers should be signed and witnessed in the same way as with the bought transfer and returned to the broker, who will arrange for delivery to the buying broker. Any delay in returning the transfers to the broker may cause him serious inconvenience,

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as a cheque for the proceeds will probably be sent to the seller on the settlement day, whereas the broker cannot obtain his money until he delivers the stock. For the same reason, it is essential that the broker should hold the relative certificate.

On receipt of the transfer or transfers for signature, the seller may be intrigued by the fact that the consideration money, as stated on the deed, differs from that on his sold contract note. This is explained by the fact that the consideration shown is that paid by the purchaser, and as several days may have elapsed between the purchase of the shares by the jobber and their sale to another buyer, it may well happen that there has been a big fluctuation in the price of the shares in the meantime. And there may have been various sales between jobbers before the ultimate purchaser is found.

“Limits” and Markings

When an investor is desirous of investing in a share, but is not prepared to pay the current price, it is quite usual to give the broker a “limit” which, in effect, is an order to buy the shares at a certain price below that prevailing, in the hope that a setback will enable the order to be executed. It is also common practice for a seller to place a limit price on shares which he wishes to sell but thinks are worth more than the current level. It is sometimes thought that placing a limit price on an order to buy or sell inside the jobber’s margin will result in the broker forcing the deal through, but very often the only result is that the investor “misses the boat”. Procrastination is the thief of time, and markets are liable to quick movements.

Whilst the practice of placing limits leads to a good deal of additional work on the part of both the broker and the jobber, they are often welcomed by the latter, as he is enabled to make a better price, knowing he is protected by the probability of being able to square his “book” by the execution of a limit. In addition, limits have a tendency to level out big fluctuations in any particular share and therefore form a useful part of market machinery.

Limits need to be carefully watched by both the broker and his client, as many factors are liable to influence the price of a share after the placing of such a limit. The shares may be quoted ex-dividend, and it would not do for the broker to assume that his client is still willing to buy shares at his price and lose the dividend. Usually the broker is warned by the jobber when the

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shares concerned are quoted "ex-dividend", and the broker communicates with his client to ascertain whether he requires to amend the price.

On occasions, a client will sometimes place a cutting limit with his broker, that is, he will instruct him to sell shares should they fall to a certain level. It requires a good deal of courage to do this, but it is a wise course to adopt if one wishes to limit a loss to a certain amount.

One of the duties of the stockbroker is to see that, after dealing, his bargain is "marked". This is done by filling up a small form on which is stated the value of the stock and the price at which the deal was done. No information as to whether the bargain was a purchase or sale is required, but the form provides several columns in one of which the price has to be entered according to whether the bargain was done on the same day as the mark, the previous day, or at a special price, etc. The special price marks are usually for small unmarketable amounts of stock or shares.

"Free" bargains, explained earlier in this chapter (page 238), also have a special mark, whilst bargains between non-members and bargains with members of associated exchanges have a special column on the marking form. Sometimes, in order to avoid dealing "free" and so charging the seller the stamp and fee, it is arranged to deal at a price which will be sufficient to cover the jobber's out-of-pocket expense incurred by buying a small, odd number of shares.

The "marks" are collected by the publishers of the Stock Exchange Official List, and the prices at which stocks and shares have changed hands are printed in this daily list, which is available within a few hours of the "House" closing. The marks are also published daily by the *Financial Times*. It should be noted that the number of bargains marked does not give a true figure of the number of bargains consummated, as a broker may do twenty separate deals in one particular share at the same price, and therefore need only fill in one mark. Then the prices at which a share has been dealt in do not always convey which were buying and which were selling marks. Nor is there any time sequence, so a high mark at the end of the line of prices may well refer to a bargain done before any of the others and vice versa. So the details must be used with caution, though marks are, in many ways, a useful guide to the investor.

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Commissions

THE commission rules as laid down by the Stock Exchange Council are the results of many years of modification and amendment. They are designed to set down hard and fast laws as to the minimum commission a broker may charge his client on any particular deal. Although the broker is not allowed to charge less than the official rates, there is no rule forbidding him to charge more. However, competition for the favour of handling a client's business is such that to all intents and purposes the scales could well be termed "Minimum and Maximum".

Section "A" of Appendix 39 of the Rules and Regulations of the Stock Exchange sets out the commissions relative to gilt-edged stocks:—

2½% Consols, 2¼% and 2½% Annuities	...	⅙ per cent on stock
Other British Government Securities	}	½ per cent on stock
Indian Government Stocks		
Metropolitan Consolidated Stocks		
London County Consolidated Stocks		
Dominion and Colonial Government Securities		
County Corporation and Provincial Securities (British, Indian, Dominion or Colonial)	}	¼ per cent on money
County, Corporation and Provincial Securities (British, Indian, Dominion or Colonial) :—		
Annuities (dealt in per unit of Annuity)		
Public Boards (Great Britain and Northern Ireland) :	}	½ per cent on stock
Inscribed Stocks free of stamp duty		
Inscribed Stocks, subject to stamp duty		
Registered Stocks whether free of or subject to stamp duty		
Metropolitan Water Board "B" stock	...	½ per cent on stock
Bank of England and Bank of Ireland stock	...	¼ per cent on money

Section "B" deals with bonds to bearer other than those in section "A". The commissions are:—

Price 1 or under	...	...	...	At discretion
" over 1 and up to 5	...	...	...	⅙% on stock
" " 5 " 10	...	...	...	⅙% "
" " 10 " 20	...	...	...	⅙% "
" " 20 " ...	...	...	...	¼% "
<i>Example—</i>				
Bought £1,000 foreign bonds at 12½.	Cost	...	...	£ 125 0 0
Commission ⅙% on stock	...	...	...	1 5 0

Section "C" deals with registered stocks (quoted per cent), registered Debentures and bonds, and applies to all stocks which are registrable and therefore subject to *ad valorem* stamp duty, with the exception of British Government Corporation and Colonial Government stocks, etc., which are free of stamp duty and are dealt with in section "A".

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The charges under section "C" are as follows:—

Price 5 or under	...	...	...	...	$\frac{1}{16}\%$	on stock
" over 5 and up to 10	...	...	...	...	$\frac{1}{16}\%$	"
" " 10 " 25	...	...	...	...	$\frac{1}{16}\%$	"
" " 25	...	...	...	...	$\frac{1}{16}\%$	on money
<i>Examples—</i>						
Bought £1,000 registered stock at 27.	Cost	...	...	...	270	0 0
Commission $\frac{1}{16}\%$ on money	...	...	...	...	1	7 0
Bought £1,000 registered stock at 24.	Cost	...	...	...	240	0 0
Commission $\frac{1}{16}\%$ on stock	...	...	...	...	1	5 0

Section "D" gives the commissions chargeable on shares or units of stock, registered or bearer (other than shares included in section "E"). These are as under:—

Price 1s. or under	...	...	At discretion		
Over 1s. to 2s.	...	...	$\frac{1}{2}$ d. per share or unit		
" 2s. to 3s. 6d.	...	...	$\frac{1}{2}$ d.	"	"
" 3s. 6d. to 5s.	...	...	1d.	"	"
" 5s. to 15s.	...	...	1 $\frac{1}{2}$ d.	"	"
" 15s. to £1 10s.	...	...	3d.	"	"
" £1 10s. to £2	...	...	4 $\frac{1}{2}$ d.	"	"
" £2 to £3	...	...	6d.	"	"
" £3 to £4	...	...	7 $\frac{1}{2}$ d.	"	"
" £4 to £5	...	...	9d.	"	"
" £5 to £7 10s.	...	...	1s. 0d.	"	"
" £7 10s. to £10	...	...	1s. 3d.	"	"
" £10 to £15	...	...	1s. 6d.	"	"
" £15 to £20	...	...	2s. 0d.	"	"
" £20 to £25	...	...	2s. 6d.	"	"
" £25	...	...	$\frac{1}{2}\%$ on the money		
<i>Example—</i>					
Bought 500 shares at 33s. 6d.	Cost	...	...	...	837 10 0
Commission 4 $\frac{1}{2}$ d. per share	...	...	...	...	9 7 6

Section "E" deals with shares of companies incorporated in the United States of America or Canada (whether dealt in in London on a dollar or sterling basis), with the exception of shares which are transferable by deed of transfer; and the details are as follows:—

Price 25 cents (1s.) or under	...	...	...	At discretion	
Over 25 cents (1s.) to 50 cents (2s.)	...	...	...	$\frac{1}{2}$ d. per share	
Over 50 cents (2s.) to 87 $\frac{1}{2}$ cents (3s. 6d.)	...	...	...	$\frac{3}{4}$ d.	"
" 87 $\frac{1}{2}$ cents (3s. 6d.) to \$1 $\frac{1}{4}$ (5s.)	...	...	...	1d.	"
" \$1 $\frac{1}{4}$ (5s.) to \$3 $\frac{1}{4}$ (15s.)	...	...	...	1 $\frac{1}{2}$ d.	"
" \$3 $\frac{1}{4}$ (15s.) to \$7 $\frac{1}{2}$ (30s.)	...	...	...	3d.	"
" \$7 $\frac{1}{2}$ (30s.) to \$10 (£2)	...	...	...	4 $\frac{1}{2}$ d.	"
" \$10 (£2) to \$15 (£3)	...	...	...	6d.	"
" \$15 (£3) to \$25 (£5)	...	...	...	7 $\frac{1}{2}$ d.	"
" \$25 (£5) to \$50 (£10)	...	...	...	9d.	"
" \$50 (£10) to \$100 (£20)	...	...	...	1s. 0d.	"
" \$100 (£20) to \$150 (£30)	...	...	...	1s. 6d.	"
" \$150 (£30) to \$200 (£40)	...	...	...	2s. 0d.	"
With 6d. rise for every \$50, or portion thereof, in price.					

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It will be noted that for the purpose of these scales it is assumed that the dollar is worth 4s., that is, five to the £. This is the "mock dollar rate", used for convenience of calculation in the London market, and although it is quite out of accord with the present exchange rate it has no effect on the commission charge, as the London price of a dollar share is adjusted to the dealing basis of five to the £.

Section "F" gives the remaining charges which can be made under the rules, and these are as under:—

Indian Railway Annuities	...	...	...	...	½ per cent on money
Options for more than one account	...	...	...	...	As on bargain
(Option dealing is suspended, but resumption has been mooted)					
Options for one account or less	...	...	...	...	} At discretion
Bargains in partly-paid stock of new issues or partly-paid shares of new issues	...	...	...	...	
Bargains in rights for cash	...	...	...	...	
Powers of Attorney for Inscribed stock	...	...	...	...	
Probate and other valuations	...	...	...	...	
Securities made-up or made-down	...	...	...	...	
Short-dated securities (having five years or less to run)*	...	...	...	...	
Transfers of stock or shares	...	...	...	...	

*Not applicable in the case of securities in default.

Small Bargains

No lower commission than £1 to be charged except in the case of

- (a) transactions amounting to less than £100 in value on which a commission of not less than 10s. must be charged; or
- (b) transactions amounting to less than £20 in value on which a commission of not less than 5s. must be charged.

The above reference to small bargains may prove rather confusing, so some examples may help:—

If the order is to sell or buy:—	£	s.	d.
100 shares of a value of 21s. per share	105	0	0
the commission payable is 3d. per share	1	5	0
Should, however, the order be to sell or buy:—			
£100 gilt-edged stock at 105	105	0	0
the commission payable is not ½ per cent on the stock or 5s. but the minimum for a bargain over £100 in value, that is	1	0	0

There are certain concessions which the broker can allow his client in special circumstances. If, for instance, an investor sells some shares in order to provide money for the purchase of other shares, or alternatively buys shares with the intention of later selling other shares in order to obtain funds for the purchase, he can ask his broker if he will charge half the usual rate of commission on reinvestment on either the purchase or the sale. It is entirely at the discretion of the broker whether the reduced

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charge is allowed or not, and there are certain restrictions and variations on the concession.

Certain restrictions also apply to the £2,500 rule and the £50,000 rule—for instance, in both of these cases the concession does not operate if the investor's order is transmitted through a bank, solicitor or other agent. The provisions of the £2,500 rule are mainly of interest to the large investor, as in accordance with its terms a broker can, if in his view the size of the order warrants it, charge half the minimum rate of commission on that part of an order which exceeds a value of £2,500. In other words, assuming the actual value of the shares or stock dealt in amounts to more than £2,500, the broker may charge the full minimum rate on £2,500 worth of stock or shares and half the full rate on the balance of the order.

In the event of an investor wishing to buy or sell an amount of £50,000 or more of any stock which is classified under Section "A" of Appendix 39 of the Official Stock Exchange Commission Rules, a special reduced charge of half the usual minimum may be made. Section "A" includes the British Government stocks and other securities listed earlier in this chapter.

A purchase of most registered stocks, Debentures, Bonds or shares attracts *ad valorem* stamp duty, stamps being impressed on the transfer deed according to the following table:—

Consideration	£	s.	d.	Consideration	£	s.	d.
Up to £5 ...	2	0		Over £150 to £175 ...	3	10	0
Over £5 to £10 ...	4	0		" £175 to £200 ...	4	0	0
" £10 to £15 ...	6	0		" £200 to £225 ...	4	10	0
" £15 to £20 ...	8	0		" £225 to £250 ...	5	0	0
" £20 to £25 ...	10	0		" £250 to £275 ...	5	10	0
" £25 to £50 ...	1	0	0	" £275 to £300 ...	6	0	0
" £50 to £75 ...	1	10	0	" £300 upwards at the rate of			
" £75 to £100 ...	2	0	0	an additional £1 per £50 con-			
" £100 to £125 ...	2	10	0	sideration money or part thereof.			
" £125 to £150 ...	3	0	0				

Every contract note, whether for a purchase or a sale, should bear an affixed contract stamp in accordance with the following table:—

Consideration	£	s.	d.	Consideration	£	s.	d.
Up to £5 ...	Nil			Over £5,000 to £7,500 ...	16	0	
£5 to £100 ...	1	0		" £7,500 to £10,000 ...	1	0	0
Over £100 to £500 ...	2	0		" £10,000 to £12,500 ...	1	4	0
" £500 to £1,000 ...	4	0		" £12,500 to £15,000 ...	1	8	0
" £1,000 to £1,500 ...	6	0		" £15,000 to £17,500 ...	1	12	0
" £1,500 to £2,500 ...	8	0		" £17,500 to £20,000 ...	1	16	0
" £2,500 to £5,000 ...	12	0		" £20,000 ...	2	0	0

BUYING AND SELLING SHARES

Stamp duties were doubled in August 1947, and this additional Government tax on Stock Exchange transactions received its share of blame for the falling off in the volume of Stock Exchange transactions which followed. One measure (perhaps more popular with jobbers than with brokers) which was adopted in the spring of 1949, and which it was thought might help to stimulate business, was the revival in slightly modified form of the "free closing" concession in force before the war. Under the relevant rule a broker may at his discretion charge only one commission for buying and selling the same security for the same client for the same account. Thus the revised concession is to operate only for transactions opened and closed during one account, and will not extend to the account immediately following, as was the pre-war practice. But with gilt-edged securities, which are governed by another rule, brokers will now have discretion to charge only one commission for buying and selling in what is the equivalent of two normal accounts—namely, twenty-eight days. Previously a somewhat similar short-term concession only applied to gilt-edged transactions of not less than £50,000 stock. Now smaller transactions also benefit.

CHAPTER XVII

INVESTING BY NUMBERS

Automatic investment systems—Chart reading—Boom and slump—Trends in the trade cycle—Dow Theory—Primary and secondary movements—Limitations of the Theory—The Hatch System—Simplicity—In and out of the market—The High Yield System—Considerable research needed—But a satisfactory income system.

It is proposed in this chapter to explain as simply as possible the underlying principles of automatic investment and the principal systems which have been evolved to meet the needs of those who like to follow such an investment policy. While many investors are keenly interested in such systems few, in this country at least, carry them out in practice. There are two main reasons for this. First, many investors find it difficult to understand such systems, and impossible to maintain the necessary data to operate them. Secondly, and more important, most investors find it difficult or impossible, for psychological reasons, to abide by the rules of the game. If a system orders its followers "out of the market" in equities, they are loth to obey. They think they know better than the system. Or they argue that they cannot afford the loss of income involved in holding cash or low-yielding fixed-interest stocks. Or the system is interpreted differently by conflicting experts. Or, simply, investors just get fun out of being in the market; they enjoy watching quotations of their shares, calculating each week how much richer or poorer they are. It is too dull watching the game from the sidelines. But is it better to be relatively dull and safe, or to buy excitement at the cost of possibly heavy capital depreciation?

It has been an illusion in the past to argue that one "cannot afford" to hold cash or fixed-interest stocks because they yield little or nothing. History shows that equities as a class can lose and have lost 50 per cent of their value with remarkable regularity in bad times. The *net* difference between equity and fixed-interest yields is slight; if an equity yields $3\frac{1}{2}$ per cent and a Government stock $2\frac{1}{2}$ per cent (and provided the latter retains its value) a fall of 50 per cent in the capital value of the equity will equal the net difference in income spread over nearly a century! It is

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also fallacious to argue that a capital loss is not a loss until it is "taken" by selling the shares, and that a subsequent boom will put matters right once more. If a share can be sold at 40s. and bought back three years later at 20s., then obviously it should be sold at 40s. even though it subsequently rises again from 20s. to 40s.

But automatic investment can only be justified by reference to history. Such systems, correctly conceived and correctly executed, have paid handsomely in past years. It does not *necessarily* follow that they will pay in the future. For most of these systems depend for their success on the periodic "swings" in markets. Boom in 1928-29, slump in 1931-32, boom in 1936-37, slump in 1939-40, boom thereafter until January, 1947—that has been the story in recent years. The investor who correctly timed his entries to and exits from the equity market over these (and earlier) periods—selling equities at the peak, reinvesting in fixed-interest securities during the slump and re-entering the equity market just before the dawn—would have made his fortune. But he would not have done so had Ordinary shares followed a dead level course. And if they should follow such a course in future, the systems might as well shut up shop.

It behoves us, therefore, to inquire in the first place why markets have in the past swung in this violent fashion. The main reason lies in what is known as the "trade cycle", the phenomenon which, hitherto at least, has characterized the business world since time began. If we start at a boom period, the trade cycle operates something like this. The whole world is optimistic. Prices are rising, demand is good. Lured on by rising prices and the heavy demand, manufacturers and producers intensify their efforts to produce more, to cash in on the situation. Supply is gradually expanded. Then, suddenly, something happens to upset confidence. Buyers delay their purchases. Orders, placed in duplicate and triplicate for the one article, melt away. Some manufacturers and producers will have been over-optimistic and will have over-extended. They cut prices to stimulate sales, and in an endeavour to "move stocks". A snow-ball movement sets in. Purchasing power is reduced, and unemployment grows. Recession, depression, slump ensue. In due course, supply is reduced to match demand, prices come tumbling down to a level which attracts buyers, and the seeds of recovery are sown.

Stock markets, with apparently uncanny foresight, have anticipated these changes in the trade cycle, both ways, by a

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period which seems to vary between twelve and eighteen months; that is to say, Ordinary shares will start to "sell off", say, a year before the indices of trade activity turn downwards and commence to rise approximately a year before trade rallies. In part, this anticipation occurs because stock market operators have their ears closer to the ground than most people. In part, it probably reflects anticipatory action by people "on the inside". Whatever the reason, it happens. And it is on the happening that most automatic systems of stock market investment have been built.

Whether the trade cycle will continue in the future as in the past it is impossible to say with any certainty. The economists have studied the problem very deeply, and argue that if the volume of capital investment (that is, investment in durable things, such as factories, houses, plant and public works) can be held stable then the trick will have been done—the consumer goods industries will look after themselves. Monetary policy will also play an important part; past slumps have undoubtedly been exaggerated because the authorities have tried to force prices down and dry up purchasing power. Most Governments now stand committed to endeavour to maintain full employment and reduce fluctuations in the trade cycle. If the Governments succeed in their endeavours, there will be no point in "investing by numbers". But if they don't succeed, properly conceived and properly executed automatic investment will continue to pay.

The Dow Theory

THE basic idea in cyclical investment is to sell equities at or near their peak ; reinvest in fixed interest stocks or cash (the former fluctuate much less than equities, particularly if they are short-dated) until equities are at or near their nadir; and then to re-enter the equity market. Expressed thus, automatic investment is the most delightfully simple business possible. How can it be therefore that every slump in the past has left the vast majority of investors high and dry with equity shares the value of which is rapidly depreciating?

The answer is, of course, that it is easy to outline the principles of automatic investment but extraordinarily difficult to put them into practice. Granted that an investor has no inhibitions against such systems from the psychological angle, how is he to know the right time to sell and to buy? Anyone can tell years after the event. But to know *at the time*, that is a different matter. The

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best-known automatic system is the one which is widely practised in America, but which has few adherents here—the Dow Theory. Many books have been written on this theory, and obviously the ground cannot be covered exhaustively here. Nevertheless, an outline of the system can be given.

At the outset, it should be made clear that not even the most ardent believer in Dow Theory claims that the theory is infallible. Apart from the schisms and heresies which often develop among the true believers, the Dow Theory, like any other system, can make mistakes. It can give a genuine selling or buying “signal” which will prove unprofitable to followers of the theory, because the subsequent fall or rise in the market will not be big enough to pay the expenses of the exit from and entry into the market. The Dow Theorist will counter by saying that you must take the rough with the smooth, and that over a period of years, possibly a lifetime, the system will pay.

The first and most important axiom of the theory is that the industrial and rail indices or averages discount everything. They reflect the aggregate experience and knowledge of all investors. The theorist must, therefore, accept the verdict of the indices without question; he must not oppose his personal “hunch” against the indices. Having accepted this cardinal assumption, the Dow Theorist works on the knowledge that there are three movements of the indices, all of which may be in operation at one and the same time. The first and vital one is the primary movement, which may represent a bull (rising) market or a bear (falling) market. This primary movement generally lasts for longer than a year, sometimes for as much as five years, occasionally even longer. The next movement is the secondary movement, which is either a sharp upward reaction in a bear market or else a sharp downward reaction in a bull market.

These reactions generally last for three weeks to three months, and each reaction usually wipes out between 30 and 60 per cent of the gains and losses made by the primary movement. Although the true cyclical investor will not be interested in or worried by secondary reactions—he either stays out “in” or “out” of the primary movement for the whole of its duration—the professional operator will often take advantage of the secondary reaction to operate, against his main conviction. Thus, in a bull market, although he is convinced that in the long run it is still right to be “in” equities, he may sell his holdings in a secondary reaction, in order to buy them back more cheaply. But this is a tricky business, as professionals often known to their cost. The third

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movement is the daily fluctuation of markets, which is of no importance.

Next, the Dow Theorist believes that the trend of both the industrial and the rail indices must confirm each other. A rise in industrials which is not confirmed by a rise in rails, or *vice versa*, is not bullish. Indeed, such a movement is one of the indications of a change in the market trend. It is unnecessary, however, for the two indices to confirm each other on the same day; a certain latitude is allowed. The use of the rail average or index has caused some criticism. Railways, the critics argue, are a declining industry. They are a "political" industry. Why not use a steel index, or a power index? In fact, given a share index of rails, there seems no reason why it should not function as well or better than any other index. Railways may be a declining industry. But their traffics still reflect, immediately, any change in economic activity in a country.

Not for the British

Dow Theory has never been very popular in this country. And it may legitimately be argued that throughout the war years it was impossible to operate it here, for the simple reason that railway stocks did not reflect, in their market values, the country's economic activity, but the rental the Government paid, the trend of interest rates and other factors. It is certainly clear that Dow Theory could not be operated in this country now that railway nationalization has been put into force. It remains to be seen whether a variation of Dow Theory will be invented for British investors, with some other confirmatory index substituted for railways.

We now come to the crux of the theory. If there are successive rallies with the top of each rally breaking into new high ground, and with the bottom of each trough ending above the recent low points, the omens are bullish. They are particularly bullish if the volume of trading increases on the upswings and falls on the declines. The converse is true for bear markets. Then you get successive falls and recoveries, with each decline going into new low ground, and each recovery ending below the previous high point. It is these movements which decide whether the primary trend of the market is up or down.

There are many refinements to the theory, and one important one should be mentioned. This is the situation which develops when the indices are "making a line". This happens when both

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indices fluctuate during a period of two or three weeks within a range of 5 per cent. During such a period, say the Theorists, the public is either selling stock to the market, or buying stock from it—and Theorists are not advised to guess which. They are told to watch the “emergence”—the direction in which the indices eventually break away from the “line”. If the “emergence” is upwards, substantially higher prices are indicated. If the indices fall below the bottom of the line, the market is due for a setback.

Unprofitable turns are not uncommon in Dow Theory. On the other hand, bull markets in New York in fairly recent years have seen rises of the order of over 300 per cent and bear markets falls of over 50 per cent, movements which afford ample scope to the cyclical investor. It should, however, be noted that in more recent years—since the end of the war—Wall Street has moved in a narrow range unprofitable for Dow Theorists’ operations.

With the main elements of Dow Theory thus very briefly outlined, it remains to consider its merits and demerits. The first point to be made is that the system is of no use to the “in and out” speculator, except to the extent that he can operate within a secondary reaction. This is not necessarily a disadvantage; short-term speculation can be a snare and delusion for the inexperienced operator, handicapped as he is by expenses which may demand a 20 per cent movement before he “breaks even”. On this score, then, the Theory gets good and not bad marks.

It is, however, a more dubious matter when we come to consider the basic principle of the Theory—that the averages know everything and discount everything. It is an interesting fact that this principle seems to have more solid foundation in this country than in America. In the 1936-37 boom, *THE INVESTORS’ CHRONICLE* Industrial Share Index anticipated a decline in trade activity by twelve months; in 1928, the index reached its peak in April—but trade activity went on rising until August 1929. In America, however, in 1929, Wall Street collapsed three months *after* and not before the trend of business turned definitely downwards. Over a long period, Wall Street has failed to show the prescience noted in London. Whatever the reason, the evidence strongly suggests that the American share indices do not, in fact, possess the infallible qualities with which Dow Theory invests them.

How is it, then, that the system does seem to work? The answer is that it only works in part; it has been stated that of ninety prognostications made by Hamilton, a pioneer of the

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Theory, forty-five were successful and forty-five unsuccessful. Tossing a penny, on this precedent, would work out just as well. The fact of the matter would seem to be that the Theory merely acknowledges that the market moves in long-term cycles, and is prepared to accept major variations in the long-term trend as evidence that the trend is about to change—often a sensible enough premise. Probably the main merit of the system is that it charts the long-term trend of the market and enables observers to get matters in some perspective. But even so, different observers will arrive at different interpretations. One observer has even been known to change his assessment from bull to bear and back to bull again, all in a matter of weeks. It may be sacrilege, but we do not believe Dow Theory to be the Open Sesame to successful cyclical investing. We do not even believe it represents the best automatic investment system. But those who would like to know more about it might consult Major C. B. Ormerod's book, "Dow Theory Applied to the London Stock Exchange" (Pitman, 7s. 6d.).

Investing with Hatch

A NEW system of automatic investing has come to the fore in recent years to take the place of Dow Theory for those among British investors who like such systems. This is the Hatch System, which was evolved by Mr. Hargreaves Parkinson, editor of the *Financial Times*, who has written books on the subject (e.g., "The Hatch System: A Primer for Investors", Pitman, 15s.). The system takes its name from an imaginary Mr. Hatch, whose cyclical investment operations Mr. Parkinson originally invented to clothe a detailed investigation into the course of American share indices since the last century. The story of Mr. Hatch's operations is, of course, a long one. But it can be summarized by saying that Mr. Hatch turned \$100,000 into \$2,055,000 between 1883 and 1938 simply by being in the American equity market while it was rising and out of it while it was falling.

"Simply?" Yes, the Hatch System has the cardinal virtue of great simplicity. There is no lore of secondary reactions, double tops and bottoms, parallels, lines, and so on. There is just a weekly and a monthly averaging of daily share values, with an addition or subtraction sum at the end of each month. If one accepts the fact that all shares of a class—say, all Industrial Ordinary shares—move more or less together—and experience suggests that they do share *major* movements—then there seems

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no reason why the Hatch System should not be operated with any portfolio of comparable shares. It is necessary to sort out the sheep from the goats in operating the system, for industrial and gold shares, for example, can stage diametrically opposed movements of major proportions over a common period. For purposes of convenience, it is as well to adopt a daily share index to illustrate the working of the Hatch System; investors can simply imagine that they are operating in, say, the thirty leading industrial equities which comprise the *Financial Times* Ordinary share index, and then the work of valuing the shares is done for them.

How and when did Hatch investors join in the major bull market which started in 1940 and ended early in 1947? The system had, of course, taken them out of industrial equities in 1936. Each week thereafter (while his money was tucked away in gilt-edged, building societies, or simply in the bank) the Hatch investor averaged the index. Once a month he averaged the four or five weekly figures and obtained a monthly average figure. So long as the monthly average kept on falling, the investor did nothing. If he thought the major or primary trend in the market had changed or was about to change, he added 10 per cent to the previous lowest monthly average. The resulting figure gave him his entry point. If despite his hunch, the primary trend did not change, or if the index did rise, but not to his entry point, he did nothing. If the index went on falling, he had to revise his ideas about the lowest monthly average to which to add the 10 per cent to obtain his new entry point.

Matters would have gone on pretty much like this throughout 1937, 1938, 1939 and most of 1940—which were all very good years to be out of equities. The slump in June, 1940, however, would have interested the Hatch investor very much. Here is the picture of the weekly averages of the *Financial Times* Ordinary share index during that month, with the weekly figures themselves averaged to give a monthly average:—

Week ended June 7, 1940	...	...	...	...	61.5
" " " 14, "	...	...	...	...	61.4
" " " 21, "	...	...	...	...	55.2
" " " 28, "	...	...	...	...	51.0
					229.1
Monthly average (229.1 divided by 4)	...				57.27
Add 10% ...	...	...	...	...	5.73
Entry point	...	...	...	...	63.00

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June's was clearly easily the lowest monthly average to date in that bear market. Addition of 10 per cent gave an entry point of 63.0. Would the index rise as far? It did—but not until the following September. On the 4th of that month, it rose to 63.5—and the Hatch investor that day would have bought the thirty leading industrials which comprise the index.

From September, 1940, to January, 1947, the primary trend of British industrials was strongly upwards. There were several sharp setbacks, some of which were sufficiently severe to cause some people to think that the bull market was over. But none was sharp enough to take Hatch investors out of the market until July, 1947. At this point, Hatch investors were working on the monthly average for January, 1947, which was the peak of the 1940-47 bull market. The exit point was 122.74, calculated as follows:—

Week ended January 3, 1947	...	...	...	135.7
" " " 10, "	...	...	...	136.4
" " " 17, "	...	...	...	139.2
" " " 24, "	...	...	...	136.4
" " " 31, "	...	...	...	134.2
				681.9
Monthly average (681.9 divided by 5) ...				136.38
Deduct 10% ...				13.64
Exit point ...				122.74

On 30th July, 1947, the *Financial Times* index fell below this level, so the Hatch investor, having "bought the index" at 63.0 in September 1940, sold around 122, having virtually doubled his money. The system erred, however, in putting investors back again into the market in December, 1947, at an index level of 123.9, for they were hardly in before they got a selling signal—of 112.8 in February, 1948. That was an unprofitable "trip" into the market. The system erred again in January, 1949, when it put its followers "in" at 122.2; they were duly taken out again at the end of the following May, when the index fell below 110. In these two "trips", investors lost some 30 per cent of their capital.

That is the essence of the Hatch system. It is as simple as any system can be. It is purely automatic. And on all the evidence to date, it works. It has one main limitation. It cannot guarantee that the subsequent movement of the index will be sufficiently

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big to have justified the purchase or sale. Thus, having given an entry signal, the system may then give an exit signal before the market has risen enough to justify the entry; and *vice versa*. This is what happened in 1947-8 and 1949. But provided the index swings by $11\frac{1}{4}$ per cent—in the right direction—the system will pay. Among the minor limitations may be mentioned: (a) That the index may rise or fall well beyond the signals before action can be taken; (b) the system cannot put investors out or bring them in at the exact top or bottom.

It is difficult to take these subsidiary objections seriously. No system will ever hit the exact bottom or top of the market. And seeing that the maximum daily variation in the index in June, 1940, was under three points, it would be churlish to complain about (a). All in all, Hatch is a useful system for the cyclical investor, but it does not dispense with the need for judgment. The system could be adapted to any class of security, although some variation in the 10 per cent rule might be necessary for other classes. Indeed, if the character of the industrial market should change—if it became subject to more violent swings than has been the case in the past—then maybe the 10 per cent may have to be increased for industrial shares. Where facilities for bear operations exist, there seems no reason why Hatchites should not have it both ways. One thing followers of the system must hope for—and that is that its adoption does not become universal. For then, to whom would they sell? From whom would they buy?

The High Yield System

So far in this chapter we have considered automatic investing entirely as a means of taking advantage of the great fluctuations in market prices caused, hitherto at least, by the fluctuations in the trade cycle. As already pointed out, however, many investors are either unwilling or unable to follow a policy of investment which may force them, for years on end, to invest their capital in low yielding fixed interest securities. They may concede that such a course is the correct one to conserve and increase capital. But they are unable or unwilling to draw on that capital during slump years to maintain their income. To meet the requirements of what may be termed the “continuous investor”, and also to prove a “hunch” of long standing, a member of the London Stock Exchange evolved what has come to be known as the “High Yield System”.

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The "hunch" referred to was simply this—it was suspected that investors as a class always overdo things. They over-estimate, it was thought, the benefits to come from certain shares by valuing them on an unduly low yield basis; they over-estimate the risk attaching to certain other shares by valuing them on an unduly high yield basis. The theory did not dispute that the investor's underlying and fundamental judgment was sound; on all past precedent, for example, shares in the consumer goods industries *are* better and more stable investments than shares in many of the capital goods industries. But it *was* thought that even allowing for the benefits and risks involved, the spread between the yields offered by low- and high-yielding investments would be proved by subsequent events to be too wide; some of the benefits would not mature, some of the risks also would not materialize, or if they did would not be so costly as expected.

To test the theory, its inventor conducted investigations, going back over a period of no less than sixty years, into the relative behaviour of low- and high-yielding securities. The results proved the theory up to the hilt. Against all the judgment of investors, it was found that high-yielding securities did secure for their holders better results, both from a capital and income point of view, than low-yielding securities—and did so through boom and slump alike. Since those initial researches the originator has been supervising a "High Yield Portfolio", inaugurated in March, 1939. And THE INVESTORS' CHRONICLE inaugurated several "High Yield Portfolios" after 31st December, 1945. All of these except one had at the date of the last "audit" "beaten the indices", so the system obviously justified itself from a capital viewpoint. From the income viewpoint, of course, it clearly provides benefits denied by "buying the index".

In evolving the system, the author was not prepared to allow investors to buy high-yielding securities indiscriminately; obviously, there may be shares giving high yields which do not overestimate the risks they involve. To provide safeguards, the system lays down that:

The sum to be invested must be spread over twenty to forty equities giving the highest yields possible, provided that the shares were quoted in the London Stock Exchange Official List and have a market capitalization of over £1 million. The middle price of each share when purchased must not be lower than it was twelve months previously, and the yield must be above the mean of the whole list under review. The portfolio so built up must be examined at regular intervals and any stock must be

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sold if the yield is then below the mean of the list, provided also that the price is below that of twelve months before. Any share upon which the dividend is passed must be sold. The funds released are reinvested in the highest yielding security available under the rules already given, or retained in cash until a share complying with the rules is available.

The chief drawback to the system is immediately obvious—that it involves an amount of research quite beyond the resources of most investors, while the need for spreading the investible funds over thirty securities may place the system beyond the reach of the small investor. To meet the first objection *THE INVESTORS' CHRONICLE* has been conducting periodical audits of the system since the end of 1945, making the results available to interested readers for a small annual charge.

Here, it is only necessary to quote the High Yield Portfolios evolved by *THE INVESTORS' CHRONICLE* to date to prove the success of the system. It will be appreciated that the contents of each portfolio vary according to the date of the audit, for the simple reason that as prices and dividends vary, so will different shares satisfy the rules at different dates. In the following table, some portfolios that were evolved at quarterly intervals from 31st December, 1945, are compared with *THE INVESTORS' CHRONICLE* Industrial Index of ninety-six shares and the *Financial Times* Industrial Ordinary Share Index of thirty shares, all three sets of figures being adjusted so that values at the initial date of each portfolio equal 100. This particular analysis shows the position at the end of June, 1948.

HOW THE PORTFOLIOS HAVE FARED

Portfolio inaugurated	IC Index* of June 24 1948	High Yield Index* of June 23, 1948	FT Index* of June 23, 1948	Average yield % on Portfolio†
Dec., 1945 ...	96.5	119.8	99.8	6.49
Mar., 1946 ...	95.1	120.7	100.3	6.40
June, 1946 ...	86.2	109.9	89.9	6.43
Sept., 1946 ...	91.2	120.8	94.1	6.65
Dec., 1946 ...	81.8	111.4	84.0	6.96
Mar., 1947 * ...	84.3	101.4	88.6	6.87
June, 1947 ...	81.1	100.3	85.4	7.38
Sept., 1947 ...	96.2	110.9	97.3	7.43
Dec., 1947 ...	89.2	96.2	88.1	7.40

*All indices are adjusted so that their base becomes 100 at the date of inauguration of the relevant portfolio. †Yield on each portfolio at the time of its inauguration.

The above figures show that (except for the portfolio inaugurated in December, 1947) all the High Yield portfolios

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showed a profit as at June 23rd, 1948. But a loss would have been suffered by June, 1948 by an investor who bought THE INVESTORS' CHRONICLE Index—i.e., had invested his funds at any of the selected dates in the ninety-six industrial shares used for that index. And the same statement is virtually true of the thirty industrial market leaders used to compile the *Financial Times* index. On this analysis, as with earlier researches, there can be no doubt that the system works from the angle of capital conservation. From the viewpoint of income, the last column, giving the average yield on the thirty shares in each High Yield Portfolio at the time of its inauguration, tells its own story. It remains to reiterate that the system does not claim to keep investors out of a falling market. But if past experience is any guide, and even when markets are falling, holders of High Yield Portfolios should at least suffer less capital depreciation and income loss than holders of more fashionable and low-yielding shares.

This was found to be the case in 1948-49. A difficult market period was experienced during the twelve months to the end of June, 1949, which provided a testing time for the High Yield Portfolio inaugurated in June, 1948 (subsequent to the specimen portfolios shown in the table on page 257). But on the point of relative capital conservation the portfolio in question, though showing a 10 per cent loss on the year, still enjoyed a slight advantage over the experience of the thirty first-class industrial stocks used for the *Financial Times* index. That advantage was more marked on comparison with the wider spread of industrials used for THE INVESTORS' CHRONICLE index.

CHAPTER XVIII

HOW TO READ COMPANY ACCOUNTS

Limitations of company accounts—Circumspection in reading them—Should be compared over a series of years—Start of a company's career—Fixing the capitalization—The balance-sheet at formation—The first year's trading—Depreciation requirements—Taxation's effect on profits—The dividend and reserve policy—Typical profit and loss account and balance-sheet—Explanation of the figures—The question of liquid finances.

COMPANY accounts have many limitations, and though some of these are removed or lessened with the new Companies Act now on the statute book, others will never be catered for by legislation. How many investors, for example, appreciate one simple fact when scanning a balance-sheet—namely, that it purports to show the company's position on one day, and one day only, out of the 365? On the day before the balance-sheet date or the day after the position may be transformed in essential details. Particularly may this be the case with a holding company which can transfer funds and other assets between itself and its subsidiaries for "window-dressing" purposes. But there need be nothing sinister in such transactions.

The profit and loss account can be equally, if not more, misleading. Until it became a legal obligation on all holding companies (except where specially exempted under the Companies Act, 1948) to publish consolidated profit and loss accounts—that is to say, a profit and loss account showing the combined and aggregate profits of all companies within the group—a holding company's profit and loss account might give an entirely spurious picture of the group's affairs. There have been companies which implicitly acknowledged that the "profit" brought into their accounts was simply the amount necessary to cover the dividends the directors of the company had already decided to pay.

Man being usually an optimist, most people assumed that a holding company's subsidiaries were allowed to retain substantial undisclosed profits in their businesses, and that in consequence shares in holding companies valued on the disclosed earnings alone must automatically be undervalued. In many cases this premise has been justified. Since July, 1948, when the new

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Companies Act came into full operation, the more informative accounts now compulsory have provided remarkable instances where more light on the position has dispelled previous under-estimation of the merits of a business. But it is not always so, as will be often revealed now that consolidated profit and loss accounts are in the main compulsory. It may be that a holding company has been taking every penny of its subsidiaries' profits. Yet the market in valuing its shares may have made the more common assumption that its directors are highly conservative folk. Unconsolidated profit and loss accounts may thus be illusory both ways.

The new Companies Act will also prevent certain companies from persisting in the practice of announcing their "profit" in the following, or similar, terms: "Profit for the year after providing for taxation, including amount reclaimed under E.P.T., deducting depreciation, amount written off investments, provision for special losses and crediting income from investments." Needless to say, the resulting figure is quite meaningless as a guide to a company's true earning capacity.

But even now that obscurantism of the kinds mentioned has been done away with, balance-sheets and profit and loss accounts will still need to be read with a great deal of circumspection. A moment's reflection will show that considerable estimation is necessary in the framing of accounts. Such items as stock, work in progress, and bad and doubtful debts among debtors cannot be stated with any real degree of precision. The Cohen Committee on Company Law Amendment realized this, and realized, too, that it would be impossible to lay down rule of thumb methods of valuation for such items which would be applicable to all companies. It did—apart from recommending "accordance with accepted accountancy principles"—consider that where *changes* occurred from year to year in the basis of valuation of such items that fact should be mentioned. Even so, in comparing a share in one company with a share in a rival business, investors should realize that they may be comparing chalk with cheese.

A similar state of affairs may arise in connection with depreciation. Of two companies on the same line of business, and with very similar capitals, one may pay a substantially higher rate of dividend than the other. The explanation very largely resides in the fact that the high-dividend paying company merely charges for depreciation the official rate allowed by the Inland Revenue authorities for this type of business. The other company sets aside much larger sums for this purpose than the

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amounts officially allowed; the extra allowance, it should be noted, has to be made from profits which have borne profits tax and income tax, so that in terms of gross earnings and dividend it would be worth twice as much at 1949 levels of taxation. Events may prove that the depreciation provision of the first company is fully adequate—though that would often be very doubtful at 1949 replacement costs. Even so, it is clear that it would be wrong to regard the two shares as comparable risks.

It is quite useless to hope to form an estimate of a share's merits by reference to *one* set of annual accounts. A company is an organism which develops towards maturity and then, as often as not, merely maintains itself or even goes into a decline. The successful speculative investor is the investor who can pick shares in companies which are in the developing or dynamic stage; mature concerns which can maintain their position will interest the more solid investor, who is unwilling to take the risks inherent in any developing business; shares in the declining companies will be found in the portfolios of those investors who either cannot or will not read the story which is being shown in successive annual accounts. In reading company accounts investors must be informed of the position as it develops year by year over a quite lengthy period.

How a Balance-sheet "Builds Up"

Now, by means of tracing the career of an imaginary enterprise, let us see how a company's balance-sheet "builds up" over a period, remembering that it is in the main through the ploughing back of profits, or the issue of new capital, that this process is achieved.

Let's start right at the beginning. We are forming a new company, to take over a private business. Here we are up against a difficulty right away. The private business has had a good profit record, and has worked its profits up to £20,000 a year. This might justify us in giving our new company a capital of £200,000 in, say £1 shares, on which it would earn 10 per cent if profits were maintained. This is the "nominal capital". The operative word is "nominal". For as we have stressed earlier in this book, neither the £200,000 total, nor the denomination of £1 which we place on the shares has any real relevance or value. Somehow or other we can arrange the assets which the capital represents so that they match the capital *at the moment of starting the business*. But a week later something quite unforeseen may have

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arrived which upsets or improves the earning power of our company and consequently the real value (as distinct from the book value) of the assets. In such circumstances, the worth of the capital sunk in the business has obviously changed too—and if the shares were quoted, their market value would reflect the change. But because British company law says that a limited company must have a nominal capital, we should still go on saying that our capital was £200,000.

There is another difficulty on this question of capitalization. The private business had, as we have said, a good profit record. But it had very little in the way of fixed assets (property, plant, machinery, and so on)—a mere £20,000. It was, if you like, a newspaper business, a firm of business consultants, a publishing house—the type of concern where the real assets are the brain power of perhaps a dozen heads. Now if we make the capital £200,000—which would be justified on earnings—we may have to put a value of £100,000 on goodwill, to make both sides of the balance-sheet agree. Such a valuation for goodwill in such a business would not be unduly high; it would amount to only five years' purchase of net profits, which is not exorbitant. But goodwill is an "intangible" asset, and is likely to attract critical comment. Being sensitive to criticism, we consider capitalizing the company at only £100,000 in £1 shares, on which the new company would earn 20 per cent if profits were maintained. In this event, there will be no value placed on goodwill in the balance-sheet, and all the financial journalists will compliment us on having a "clean" balance-sheet, a "healthy" position, etc., etc.

The market, however, has a habit of almost ignoring balance-sheets when it values shares. On the first, the £200,000 capitalization, the market would say: "£1 shares earning 10 per cent and probably going to pay $7\frac{1}{2}$ per cent? We'll start them at par." The *market* capitalization would, therefore, obviously be £200,000. On the second, the £100,000 capitalization, the market would say: "£1 shares earning 20 per cent and probably going to pay 15 per cent? We'll start them at 40s." The *market* capitalization would, therefore, again obviously be £200,000. In fact, the market capitalization would be the same in both cases, and the yield on the shares would be the same in both cases, because in the main the market values shares on a company's power to earn and pay dividends, not on what the balance-sheet shows. In fact, the £100,000 value of goodwill would still be there, even if we limited the nominal capital to

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£100,000. It would be in the market price, not in the balance-sheet. Here is our second moral—don't condemn a share just because it's got intangible assets in its balance-sheet. Don't reject such a share in favour of another with a "clean" balance-sheet, at least not until you have worked out the goodwill hidden in the market price of the second company's shares. "Goodwill", as shown in a balance-sheet, in short, is entirely a matter of how the company happens to be capitalized.

With these reservations in mind, let's look at our imaginary company's finances. It is the week after the company has been formed, received its capital and paid for the assets it is acquiring. Let's stick to the £200,000 capitalization. If a balance-sheet were struck now, this would be the position it would portray:—

LIABILITIES		ASSETS	
	£		£
Capital (in £1 shares) ...	200,000	<i>Fixed Assets—</i>	
Creditors... ..	2,000	Premises	15,000
		Furniture and fittings	5,000
		<i>Current Assets—</i>	
		Stock in hand... ..	1,000
		Debtors	1,000
		Government securities	50,000
		Cash	15,000
		<i>Intangible Assets—</i>	
		Goodwill	100,000
		Preliminary expenses...	15,000
	£202,000		£202,000

The company, of course, has not really done any trading yet, so that the effect of ploughing back of profits cannot yet be seen. The liabilities side of the balance-sheet at the moment is uninteresting—it merely shows the liability of the company to its shareholders and to those people who have given it credit in the ordinary course of business. The assets side is more interesting. It enables us to classify the assets into their three main headings—Fixed, Current and Intangible. Fixed assets are—fixed assets, assets fixed in the business. Current assets are sometimes called "quick" or "liquid" assets—they are easily realizable, and often realizable "outside the business. Goodwill is intangible—but valuable so long as earning power holds up. The really conservative will say it is better written out of the balance-sheet, but writing it out will not wipe it out. Preliminary expenses—the expenses incurred in forming the company—are both intangible and inevitable. But they should definitely be written out at the earliest possible moment, for they are in no sense a real asset. Other intangible assets encountered in balance-sheets are

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expenditure on patents, development, advertising, etc. Some of these are borderline cases—patents, for example, may be very valuable. In general, however, cautious directors will write them off as soon as possible.

The “liquid position” of our company is very comfortable. Current assets total £67,000, current liabilities (in this case “creditors”) amount to only £2,000. We thus have “net liquid assets” of £65,000, a happy position. Indeed, some shareholder may ask why we don’t employ more of our resources “in the business”, unless we do something about it.

Types of Reserves

Now assume that an interval of one year elapses. Our company, it may be recalled, took over a private business with a good profit record culminating in a profit of £20,000 in its last year of business as a private concern. Trading in the first year as a public company has been even better, and our company has earned a net trading profit of £25,978. This profit, as we emphasized earlier, needs definition. In the striking of it, we, as directors, with the aid of our auditors, have had to estimate the value of such items as stock in hand, work in progress, bad debts, and to decide whether we need to make provision from profits for losses among these items. To that extent, our profit of £25,978 is an approximation; we may find in a year’s time that we have been over-cautious in such provisions, or we may not have provided enough. If we have been over-cautious, we may decide to allow next year’s profits to have the benefit. Or, more likely, we shall decide to let sleeping dogs lie, in which case “secret” or “hidden” reserves may begin to be a factor in our accounts; our stock in hand, for example, may actually be worth a good deal more than the figure at which it appears in the balance-sheet. Secret or hidden reserves may also come into being through the provision of over-heavy depreciation, or through the appreciation of the monetary value of assets by inflation.

To return to our first year’s net trading profit of £25,978. This may be supplemented by such items as investment income, drafts from reserves, non-recurring or exceptional profits, etc. In the case of our new company, however, we will assume for the sake of simplicity that the profit of £25,978 includes any investment income and is not bolstered up by any exceptional items. From this profit are deducted certain charges which are of a compulsory nature—provision for depreciation, Debenture or loan

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or mortgage interest and taxation. Depreciation (up to the limit allowed by the Inland Revenue) and Debenture interest are "allowable" items for taxation purposes. (In the case of Debenture interest, this is in practice allowed as a charge for profits tax but not income tax.) Our company is allowed to set aside, say, £1,000 per annum for depreciation and has no loan capital. We may say, therefore, that it will be assessed for taxation on a profit of £24,978.

In practice, company taxation is payable in whole or in part in the year following that in which the profits have been earned. But provision has to be made in the year in which profits were earned, and the modern trend is to build up a taxation reserve which provides not only for the liability of the previous year, but for that on current profits. It can be argued that advance provision for taxation constitutes a "free reserve"—that is, a reserve which is available for distribution as dividends—since the liability to pay it has not yet arisen. By way of contrast, provision for taxation already due is a "specific reserve". Shareholders can make no claim to it, and in calculating the "asset value" behind the capital such specific reserves must be deducted.

To-day a company has to provide profits tax and income tax. The former is levied at 25 per cent (5s. in the £) over the whole of the assessable profits, but there is a 15 per cent rebate in respect of retained or undistributed profits. Income tax is levied at the standard rate over the whole of the remainder. It will be appreciated that it is impossible under the profits tax to say exactly how much a company's tax liability will be, because a dividend requires the sanction of shareholders at the annual meeting, which meeting is, of course, held *after* the accounts have been made up. However, we can make a close estimate of our liability. Indeed, it may strike us as being a good idea to transfer to tax reserve the full liability for profits tax (at 25 per cent) and income tax, regarding the 15 per cent rebate in respect of retained profits as a reserve in anticipation of future tax liability. Thus our tax liability, in simplified terms, would be:—

						£
Net trading profit after depreciation	...	...	...	...	...	24,978
Profits tax at 25% on £24,978	...	...	...	...	...	6,245
Balance	...	...	...	...	...	18,733
Income tax at 9s.	...	...	...	...	...	8,429
Net profit	...	...	...	...	...	£10,304

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It will be seen that taxation has been charged over the *whole* of the assessable profits. Now a company consists of its shareholders, and in the great majority of cases in paying dividends to its shareholders a company acts as tax collector for the Government—it pays to shareholders the net amount due to them and sets off the tax deducted against the total tax payments it has provided. (This is why it is fallacious to say, as it often is said, that if company dividends—as distinct from profits—fall the Government will collect less income tax from companies; it collects it regardless of dividends.) Thus, if taxation is charged in our profit and loss account as shown above, and if we decided to pay a dividend of $7\frac{1}{2}$ per cent less tax, requiring £15,000 gross, we shall show the dividend in our profit and loss account as requiring only £8,250 “net”, because we have already charged the tax on the dividend at 9s. in the £ in making our total tax allocation. This is the modern method. Some few companies, however, still charge dividends “gross” in their profit and loss account, in which case the initial tax allocation will *appear smaller* and the amount of the dividend *larger*. Where a company changes over from showing the amount of dividends “gross” to showing them “net”, as many have been doing recently, accounts need studying with great care, for the effect may be to mask the true trend.

To return to our profit and loss account. We have £10,304 net available, of which we propose to pay away £8,250 net in dividends. We can therefore “plough back” £2,054 into the business. We could put the whole or part of the amount to free reserve, calling it “general reserve” or “dividend reserve”, or just “reserve”. Or we could carry forward £554 at credit of profit and loss account and put £1,500 to reserve, or put £554 to profit and loss and use £1,500 to reduce the intangible asset, preliminary expenses. There are some subtle nuances here. While all the reserves discussed here are “free” reserves, as already defined, some are more free than others. Most directors regard the credit at profit and loss account as something available to be drawn upon quite freely in future years. A dividend reserve, too, is established to be drawn upon quite freely. A general reserve, however, is probably viewed as less free than either of the previous alternatives. And if we use our £1,500 to reduce intangibles we have been really conservative, for there will be no corresponding reserve item upon which shareholders could cast covetous eyes in the future. (We are hardly likely at some time in the future to “write up” the value of intangibles to

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bring a reserve into existence.) But let's be really conservative. This, then, would be our profit and loss account:—

	£		£
Depreciation	1,000	Net trading profit ...	25,978
Provision for taxation ...	14,674		
Dividend of 7½%, less in-			
come tax	8,250		
Written off preliminary			
expenses	1,500		
Carried forward to credit			
of profit and loss account	554		
	£25,978		£25,978

And this was the effect which the disposal of the residue of the profit, after allowing for the payment of dividends and the provision for taxation, had upon the company's balance-sheet. (We have deliberately kept these items out of the balance-sheet to simplify that document. They could have appeared therein, among liabilities, in which case, of course, our holdings of Government securities and/or cash would have been correspondingly higher):—

LIABILITIES			ASSETS		
	Pro	At end of		Pro	At end of
	forma	1st year		forma	1st year
	£	£		£	£
Capital (in shares) ...	200,000	200,000	<i>Fixed Assets—</i>		
Creditors ...	2,000	6,874	Premises ...	15,000	14,250
Profit and loss account ...	—	554	Furniture and fittings ...	5,000	4,750
			<i>Current Assets—</i>		
			Stock in hand ...	1,000	10,146
			Work in progress	—	16,308
			Debtors ...	1,000	9,777
			Govt. securities	50,000	*25,000
			Cash ...	15,000	13,697
			<i>Intangible Assets—</i>		
			Goodwill ...	100,000	100,000
			Prelim. expenses	15,000	13,500
	202,000	207,428		202,000	207,428

*Market value £24,302.

Interpreting a Balance-sheet

SIMPLIFIED though this balance-sheet is, there is plenty of scope for discussion. First, let us throw light on one point which often puzzles investors. That is simply the description "Liabilities" given to the items on the left-hand side. Where these items are creditors, taxation reserve, pension fund reserves, and so on,

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the description puzzles no one—such items clearly represent liabilities to people outside the company (i.e., to persons other than its shareholders). But investors sometimes contend that capital and, more particularly, reserves (and as we saw earlier, a credit at profit and loss is merely a form of reserve) are assets, not liabilities. The fact is that a company's capital and its free reserves are one, and that they represent the company's liabilities to its shareholders. Reserves (excepting capital reserves arising from share premiums and so on) reflect, on the liabilities side of the balance-sheet, a ploughing back of profits.

But satisfactory though a strong reserve position may be, investors, in interpreting accounts, should not become obsessed with reserves. For one thing, now the naive prohibition of free share bonus issues has disappeared, a company which on one day has reserves equal to 100 per cent of its issued equity capital may the next day decide to distribute a 100 per cent Ordinary share bonus. Then, clearly, it will have no reserves. But equally clearly it will be in no way a worse company in which to invest money. Again, a company may use its profits to write down its assets without placing a penny to reserve—our imaginary company would be a case in point if it applied £100,000 of its profits over a period of years to writing off goodwill. We may conclude on this point that the growth of reserves over a period is evidence, but not conclusive evidence, that a company is ploughing back money into the business to maintain or increase earning power. Once more, we come back to earning power and its preservation. It is to gauge earning power that we study company accounts.

Now let us turn to the assets side of our balance-sheet. First, the effects of the disposition of our first year's profits can be seen in the reduced values placed on fixed assets (reflecting the allocation of £1,000, split as to £750 for premises and £250 for furniture and fittings, for depreciation). Secondly, there is the reduction of the "value" placed on preliminary expenses, reflecting the allocation of £1,500 for this purpose from profits. But contrast of the *pro forma* balance-sheet with that drawn up at the end of the first year's trading tells us much more, if we make the figures reveal their story.

As one would expect with a business starting from scratch, ours is an expanding business. Despite the reductions in fixed and intangible assets, the balance-sheet totals have increased by £5,428, representing partly the increase in creditors and partly the profit and loss credit. Moreover, within the increased grand

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total, there are some quite significant changes. What are sometimes called the "trading assets"—stock in hand, work in progress and debtors—are all substantially higher. Rightly or wrongly, our company is following an aggressive policy. One reservation must, however, be entered here. A balance-sheet is necessarily a financial document, not a physical inventory. A company's balance-sheet may show that the value of its stock is higher, but if it is a time of strongly rising values, the actual physical level of its stocks may be lower, not higher. Provided, however, that there is no reason to suspect that financial inflation is disguising physical contraction, and provided that they trust their directors' business acumen, shareholders should regard expansion of trading assets as a good thing. Conversely, contraction in such items as stock in hand and work in progress may be a danger signal—it may mean that the company is running short of the raw materials which are essential to profit earning. Here again, if contraction occurs at a time when financial values are rising, the danger may be even greater than the balance-sheet suggests. On the other hand, of course, contraction in trading assets may merely mean that the directors, fearing a fall in prices and being prudent men, are shortening sail in anticipation of the price break. Obviously, there can be no hard and fast interpretations of such changes. But these are the considerations investors should keep in mind when weighing their import.

To finance the expansion of our trading assets, we have been forced to sell half our holding of Government securities. There is nothing wrong in this—we are in business to trade, not to hold unnecessarily large amounts of Government paper. But any shareholder should examine his company's balance-sheet to see whether the liquid position is adequate. At the end of the first year, our current assets totalled £74,928 and our current liabilities £6,874, so that our "net current assets" were £68,054, an ample figure, for the gilt-edged stocks and cash represented £38,697 (or, allowing for the depreciation in investments, £37,999). This closer definition of "net current assets" may be important. If, for example, as sometimes happens, they are very largely represented by debtors or work in progress, and if these items are subject to dispute, an apparently very comfortable liquid position may prove to be the reverse. (This sort of situation crops up when, for example, war contracts are being thrashed out and their terms disputed.)

In an examination of the liquid position will often be found a pointer to the probability of a new issue of capital—a material

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consideration at a time when new issues may depress the market price of existing shares. Here again, however, a reservation must be made. In considering a company's liquid position, a great deal turns on the nature of the business. It may be a "self-financing" business, which gives little or no credit and which collects its income as it goes along, day by day. Obviously, such a company can get along with very little in the way of net current assets—it may even show an excess of current liabilities over current assets—and what might be called a "strained liquid position" may by no means point to an impending new issue or resort to bank finance.

CHAPTER XIX

ACCOUNTS, EARNING POWER AND ASSETS

How to calculate a company's earnings—Distributed profits tax complications—Elucidating accounting changes—Gross and net dividends—Tax-free payments and their adjustment—Tax-free preference dividends—Assets' break-up value—Assets a pointer to earnings—Methods of estimating their value—The 1948 Companies Act—Major developments in accounting requirements—"New look" for balance-sheets and profit and loss accounts.

EVERY investor should have some notion of what his shares are earning. A very potent element in the market status of a share is dividend yield—that is, the percentage of interest which the shares actually return on the money invested in them. But very often with a sound undertaking whose shares give a "dividend yield" of 4 per cent we might find that what is called the "earnings yield" would be as much as 10 per cent. The spread between dividend yield and earnings yield will then help to fix the market price of the issue.

To illustrate this we may imagine a £1 Ordinary share paying 8 per cent dividend and quoted at 40s. Obviously the dividend yield (ignoring any dividend in the price) would be 4 per cent. But if the company actually earned (as distinct from paying) 20 per cent, and applied the balance of earnings to strengthening the position, the quotation would show an earnings yield of 10 per cent, so long as the shares remained at 40s.

In ascertaining earnings we must first consider what is a net profit, and should use the figures for the group rather than those of the parent company, where the parent has subsidiaries. The net profit for the purpose of calculating percentage earnings on the Ordinary capital may not be the same thing as the net profit as stated in the annual report from the point of view of an accountant. Again, it may not be identical with the taxable profit, which is not necessarily found on public view in the accounts, and which represents the Inland Revenue's idea of the profit upon which the company must pay taxes. Deductions which must be made before calculating percentage earnings obviously include depreciation, Debenture interest (and usually redemption charge too), directors' fees, and the like; and care must be taken to exclude any abnormal revenue items, such as

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any profits relating to previous years, profit on sale of investments or other assets, or a tax refund or adjustment.

Distributed profits tax must also be taken off; and the manner in which the company's profit and loss account states its income tax charge must be ascertained. The next step is to deduct Preference dividends, and in appropriate cases such items as Preference redemption charges. The year's surplus over all these would be the amount earned for the Ordinary dividend. We must then deduct the Ordinary dividend; and whether it happens that dividends are shown on a gross basis in the accounts, or on the more up-to-date method of showing dividend requirements on a net basis, does not really matter in this connection.

In either event the net surplus profit remaining after meeting all dividends (including the Ordinary dividend) is the surplus earnings applicable to the Ordinary capital, and this sum has borne income tax in the normal run of instances. The surplus therefore has to be grossed up (with tax at 9s., divided by 11 and multiplied by 20) in order to arrive at the total gross percentage which the company could have paid on its Ordinary capital had it distributed all its profits for the year. That total will consist of the gross dividend percentage plus the gross percentage represented by the surplus earnings. The foregoing represents the traditional method of estimating percentage earnings, but in most cases now some modification is necessary to allow for profits tax.

Calculation of the total percentage earned has been considerably complicated by the introduction as from the beginning of 1947 of the distributed profits tax. This tax at the time of writing (summer 1949) is 25 per cent on all dividend payments and 10 per cent on undistributed profits—both dividends and profits being calculated before deducting income tax. Hence in estimating what percentage a company could have paid on its Ordinary capital regard must be had to the fact that the deduction for distributed profits tax increases proportionately to the gross amount of dividends distributed, and so in itself reduces gross earnings for the equity. While it is not uncommon for calculations of percentage earnings to ignore distributed profits tax complications, it is better to err on the side of conservatism; and of the various ways in which allowance for the new tax can be made (a good case can be argued for each of several methods) the simplest and most conservative is a 25 per cent deduction from the company's profits as they stood before allowing for any U.K. taxation. This will result in understating percentage

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earnings very slightly in the average case, but the difference is not usually important; and we should always recognize in any event that any percentage estimate is—just an estimate.

So since companies now have to state their U.K. taxation charge in the profit and loss account, we are now able to add back both profits tax and income tax to the net profit so as to arrive at profits before U.K. taxes. From profits before U.K. taxes one quarter can then be deducted as approximate adjustment for profits tax. From the balance the Preference dividends (if any) must be deducted at their gross amount—i.e., before deducting income tax. The excess will represent the year's gross Ordinary dividend plus the year's gross surplus over that dividend. Relating that excess to the Ordinary capital, we obtain our estimate of the percentage earned on such capital; and as in this case the figures already include income tax no "grossing up" process is needed by this method.

We can use the figures assumed for our imaginary company when dealing with profit and loss accounts (Chapter XVIII) to illustrate the procedure, so disclosing earnings of over $9\frac{3}{8}$ per cent gross:—

Net trading profit after depreciation	...	...	£
			24,978
Assume profits tax at 25% on £24,978	...	...	6,245
			18,733
Balance (equal to $9\frac{3}{8}$ % gross on £200,000 capital)			£18,733

Our company, it will be recalled, decided to pay only $7\frac{1}{2}$ per cent dividend, which would entail a total profits tax charge of only £4,747 (£3,750 on distributed profits plus £997 on retained profits). Had it decided to pay 9 per cent, profits tax would have taken £5,198 in all and gross earnings would have been $9\frac{3}{8}$ per cent.

The understatement of percentage earnings by this simplified method is negligible where the company's capital is all in one class. The error increases somewhat where Preference capital ranks before the Ordinary capital; but even in the case of a highly-g geared equity capital—e.g., even where Preference capital is seven-eighths of total capital—the divergence is not particularly important in practical work.

It is commoner for companies to state their income tax charge in detail than it used to be. And although we really aim to secure a final figure of percentage earnings which is on a gross basis, and is therefore inclusive of income tax, it is sometimes convenient for the purpose of calculation to take off income tax and

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work out our calculation on a strictly net basis. The resulting figure can be grossed up to allow for income tax, and if we have made our calculation correctly, and have handled profits tax problems with success, we shall then have the amount per cent gross (i.e., before income tax deduction) which could have been paid by the company had it chosen to distribute its profits up to the hilt—not necessarily a commendable policy, of course.

Towards the end of Chapter XIV in this volume we have explained the devastating effects of present-day taxation on the sums which companies can retain for the purpose of keeping their plant and other working assets in good shape. Industry's capital assets in this country are being gradually run down at a time when it is essential that everything should be done to maintain or augment their earning capacity, and this fact has an important bearing on the theoretical earnings percentages we have just been discussing. Broadly speaking, the difference between the dividend percentage paid and the earnings percentage calculated represents the amount which the company could spend on maintaining and improving its capital assets out of revenue—the only sound policy. But with replacement costs so high, and with Inland Revenue tax-free depreciation allowances so low relatively to costs doubled or more since 1939, part of the taxed profits represented by the surplus percentage earnings may have to be diverted to extra depreciation allowances, beyond those recognized by the taxing authorities. On that ground, all post-war percentage earnings calculations have to be treated with caution nowadays, for they may not be as good as they seem. Minor reliefs granted in the 1949-50 Budget need not modify these remarks.

Taxation and Dividends

THERE are some refinements of profit and loss accounting which need clarification—for example, the position which arises when a company changes over from the practice of showing its dividends gross to showing them net, and the accountancy of the “tax free” dividend.

The presentation of dividend disbursements net is for the most part a modern development, urged by the Institute of Chartered Accountants but not given statutory backing in the new Companies Act; the latter merely stipulates that a profit and loss account shall make it plain *how* a company's dividends are charged, though it lays down that the balance-sheet shall show

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the net requirements. We need not concern ourselves here unduly with the arguments for and against showing dividend payments gross and net. But we must concern ourselves with the practical results of a *change* in policy in this respect, for such changes are not infrequent.

Let us imagine a company with an equity capital of £1,000,000 which issues the following statements of profits in respect of consecutive years in which the standard rate of income tax was unchanged (e.g., for 1944 and 1945, when it remained at 10s.):—

	1944		1945
Net profit	£100,000		£100,000
Dividend 5% less tax	£50,000 gross		£25,000 net
Balance (after tax)	£50,000		£75,000
Equals	10% gross		15% gross
Total earnings (dividend plus balance) equal	15% gross		20% gross

Superficially, the company earned the same profit in 1945 as it did in 1944. In fact, however, if you dig into the figures a little, you will find that the company earned £25,000 more in 1945 than it did in 1944. For before striking the 1945 profit, the company had provided £25,000 for the income tax payable on the dividend, whereas the profit in 1944 included the tax on the dividend. Where a company changes over from showing dividends gross to showing them net, it is necessary, to obtain a fair comparison, to add the tax on the dividend back to the net profit figure; thus, in the case in point, the true figure to place against the £100,000 earned in 1944 is £125,000 for 1945. When income tax was 10s. in the £, this was a simple matter. Now that a 9s. rate is effective, the net dividend would represent not 10-20ths of the gross, but 11-20ths, and the tax on the dividend in question to be added back would be £22,500, not £25,000.

All this may seem somewhat academic. But in reality it can be very important. In the majority of cases, companies change from showing dividends gross to showing them net because it is now accepted practice to do so. But there is reason to suspect that the change is sometimes made deliberately to make the latest profits appear smaller than they are. Indeed, cases have been known where a chairman has complained that profits have fallen, whereas, in fact, if a true comparison is made, they have risen!

Now for tax free dividends. Years ago, when the rate of income tax was not so far away from the Gladstonian few pence in the £, tax free dividends were commoner than they are to-day, and they were certainly less of a nuisance to the shareholder and to Stock Exchange operators when the difference between

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the gross and net receipt from dividend payments was less imposing than it is in these days of the present *gs.* rate.

There is clearly a fairly widespread impression among investors—and possibly among some critics of the capitalist system—that a “tax free” dividend really is tax free. This, alas, is not so—there is very little which is free these days. The essential point to which investors should cling is that the whole of a company’s profits as determined for income tax assessment are chargeable to that tax, whether they are distributed or not. It matters not how the company shows its dividend and reserve allocations in its profit and loss account, nor how it describes its dividend. The whole of its profits after deducting such allowances as the Inland Revenue authorities permit must bear tax. Thereafter, when a dividend is payable out of profits which have borne tax, the company has the right to deduct from each dividend income tax at the appropriate standard rate. If it does so, the company must give a certificate of deduction, which is found on the dividend warrant.

Two companies, each with £1,000,000 capital in one class of shares, may each be paying £100,000 in dividend, equal to 10 per cent gross. Company A will announce a dividend of 10 per cent less tax; this, though it takes £100,000 gross, is only equal to £55,000 net, after deducting U.K. income tax at *gs.* in the £. Company B will adopt the less common practice of announcing a dividend of 5½ per cent tax free; that also means £55,000 net for the shareholders, for Company B (like Company A) will deduct £45,000 for income tax at *gs.* before making out its dividend warrants for the distribution, which in both cases aggregates £100,000 gross. The effect, it will be seen, is the same in both cases; both sets of shareholders receive £55,000 net; a 5½ per cent tax free dividend, grossed up with income tax at *gs.* in the £, is equivalent to a gross payment of 10 per cent. Similarly a 10 per cent tax free payment is equal to over 18 per cent gross while tax is at *gs.*—18.18 per cent gross, to be exact. If we were ever lucky enough to see U.K. income tax at, say, 7*s.* 6*d.*, however, the gross equivalent of a 10 per cent tax free payment would sink to 16 per cent.

If a comparison of the long-term trend of tax free dividends and earnings over, say, ten years is required, accuracy can only be achieved by adjusting all the calculations from a net to a gross basis. In 1937, when income tax was 5*s.* in the £, a 25 per cent tax free dividend was equal to 33⅓ per cent less tax. In 1949, with tax at *gs.*, 25 per cent tax free was equal to almost 45½ per

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cent less tax. With a company which declares dividends tax free, corresponding adjustments have to be made to percentage earnings on the Ordinary capital also. So we see that announcement of dividends tax free tends to obscure the exact trend of dividends even to professional operators. When busy brokers and jobbers are in the hurly-burly of the market itself they are not in a very good position to enter into nice calculations involving income tax adjustments. Where there has been a fall in the income tax rate during the year, a tax free dividend may rise, and yet leave the equivalent gross payment unchanged. In such cases the first impulse is to put prices sharply higher on the mistaken view that there has been an increase in the gross payment also. Prices are naturally adjusted in self-defence by jobbers, and early buying or selling orders may be influenced by similar lack of opportunity for mature consideration. Then afterwards, when everybody has sorted things out, and it is realized that the dividend is really unchanged, the price of the shares comes back again, having had a quite unnecessary period of excitement.

The position is different if it is a tax free Preference dividend which is involved. The gross amount distributed to holders of a tax free Preference issue will vary as the rate of tax varies. Thus, if we have an issue of £1,000,000 5½ per cent tax free Preference shares, their gross dividend paid in 1949 will require £100,000 per annum, which is the amount required, with tax at 9s., to provide their contractual right to receive £55,000 net per annum. When income tax was 10s. in the £, the dividend would have cost the company £110,000 gross; if tax ever falls to 5s. in the £ again, the cost to the company would be only some £73,000 per annum. The tax free benefits attached to such a share are in no way illusory, because it is a prior charge with a right to a fixed dividend, the worth of which, however, fluctuates with the income tax rate. There are, of course, some Preference shares which are "free of tax (for example) up to 6s. in the £". Here the calculation of the cost of the dividend is a good deal more involved, but within the obvious limit the broad effect is as described.

When a company distributes the proceeds of the sale of its assets, such distributions are genuinely tax free. Neither the company nor the recipient is mulcted of tax in respect of these payments, because they are in effect a return of capital, and capital is not normally subject to tax under our laws.

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The Use of Asset Values

HAVING (we hope) disposed satisfactorily of the revenue aspect of accounts, we may now consider asset values. The main objective of the student in analysing company accounts is to ascertain a company's power to earn profits, in the past, at present and in the future. Yet the analyst of a balance-sheet may be solely interested in ascertaining what is known as the "asset value" of a company's Ordinary shares. In such studies lie the seeds of interminable investment disputes.

Now it is perfectly true that break-up values have direct investment significance in only a limited number of cases. Dying gold mines, nationalized companies and, occasionally, investment trusts do go out of business and distribute their assets or the proceeds of them among shareholders, after satisfying the claims of creditors, prior charge holders, etc. In such cases, it is useful to be able to calculate break-up values, particularly as the shares of such companies are often quoted below the break-up value—because liquidation may be a long business, with its own uncertainties, and also because many investors want continuing investments. But even where a company has not the slightest intention of going into liquidation, there is complete justification for calculating asset values.

Let us take a simple case to illustrate our point. A company runs a shipping service between this country and France. It is the only company operating this particular route. Its directors have stated that the company will never go into liquidation. Its assets are worth 20s. a share at current replacement costs. Its shares can be bought in the market at 10s. The "asset value argument" for the shares is this: You are, in effect, buying ships at half the price which any new competitor would have to pay for them. Therefore, if there is to be competition, the newcomer, with his higher capital costs, must charge freights sufficiently high to cover his depreciation and provide a return on his capital costs. At such a level, your company will have no difficulty in earning sufficient profits to give a good return on the value placed on the business by the market. If the capital cost of new ships is too high for the would-be competitor to stomach, then your company will continue to have a monopoly, in which case it can fix the freights at its own level. So the "asset value argument" is not an argument for asset values *in isolation*. It uses asset values as a pointer to future earnings probabilities.

The "asset value argument", of course, needs to be used with

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a good deal of circumspection. If some eccentric millionaire built a super-cinema in the heart of the Sahara, or a refrigeration plant at the North Pole, analysis of the balance-sheet might show a most impressive asset value behind the shares, but obviously the calculation would be of no practical value whatsoever. Attention must be paid to the *type* of asset involved, which is another way of saying that earning power enters, once more, into the picture. But if the investor can buy 20s. of assets for 10s., and if those assets consist of cash, realizable investments or some desirable property of some kind or another, then the market is in effect saying that it does not believe that those who manage the company know their business.

In ascertaining asset values from a balance-sheet, it is necessary to exercise a certain degree of judgment and to remember the limitations of a balance-sheet as a guide to the present realizable value of a company's assets. To-day the majority of companies vastly understate the monetary value of their assets. Where these were purchased some years ago, the inflation we have seen may have raised monetary values by 200 or 300 per cent. Generally speaking, the analyst can make little or no allowance for this change in monetary values. Sometimes, however, it *is* possible for the analyst to "get a line" on the current values, as with the shipping industry, and in such cases it is permissible to calculate two asset values, one based on the official balance-sheet figures and the other on the analyst's own estimate of current values. It should, of course, be made quite clear which course has been adopted.

Judgment is necessary because it is not possible for the outside observer to know whether certain items on both sides of the balance-sheet should be included or excluded. It is a good rule, however, always to err on the side of conservatism in calculating asset values. Thus, if there are intangible items among the assets, it is generally as well to exclude them. And if the analyst is in doubt whether a reserve or other liability relates to shareholders or someone outside the business, it is safer to assume that it does not relate to shareholders.

Then it is a simple matter to tot up the total value of assets and to deduct from that total all items due to people outside the business (creditors, tax reserves, bank loans, staff funds, etc.), and prior charge commitments. Care should be taken to allow for any premium payable to holders of prior charges on redemption. And it will sometimes be found that holders of Preference stock or shares are entitled in a liquidation to rank

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equally with the equity in the proceeds of liquidation. Normally, where the equity gets the whole of the net proceeds, it is a simple matter to divide those proceeds by the number of issued equity shares to obtain the asset value attributable to each equity share.

If the Preference capital participates, the matter is more complicated. It is conceivable that a board of directors, knowing that liquidation lay a year or two ahead, might, in anticipation of that event and to forestall Preference participation in liquidation, make a special distribution to holders of the equity by way of return of capital or dividend not subject to tax. Because of such possibilities, the safest course is to make two or more sets of calculations on the assumptions which seem most probable, i.e., assuming that both Preference and equity participate equally in the net proceeds, or that the Preference will in the event merely get par, or that they will get some "concession" over par but short of their full rights. Here again, whatever basis is adopted it should be clearly stated. One final word—sometimes the usual reference sources are silent or deficient on the liquidation rights of the various classes of capital. The really efficient analyst will obtain a copy of a company's articles of association to see what these have to say on the subject. Even articles of association have been known to leave the matter in the air, however, and then, in certain circumstances, it may be worth while getting counsel's opinion on the position. In one or two recent cases, it has been held that where the articles are silent, a Preference stock is deemed to rank *pari passu* with the equity in liquidation.

Changes under the 1948 Companies Act

ON the question of asset values generally, the coming into force on 1st July, 1948 of the new Companies Act signifies some major developments, for with practically all company accounts brought into full conformity with the Act investors as a body will have much more information than they had before.

The most notable change is that after 1st July, 1948 it became necessary for a company to present a consolidated balance-sheet and a consolidated profit and loss account. All too often the profits shown by a company had hitherto consisted of its own direct trading profit plus dividends from subsidiaries, without any indication of the amount of profit retained by those companies. In such instances shareholders were left completely in the dark about the true earning capacity of the group as a whole.

The presentation of group accounts does set some pretty

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accounting problems, but the qualifications to the general direction should enable companies to adjust themselves without undue pain. Thus, group accounts may be presented in forms alternative to that of the full-blooded consolidated statement if the company's directors think that this is better for the purpose of presenting the same or equivalent information and of so presenting it that it may be readily appreciated by the shareholders. In addition, a company may omit a subsidiary (or all subsidiaries) from consolidation if the directors consider that consolidation would be impracticable, or of no real value in view of the insignificant amounts involved, or would involve disproportionate expense or delay; if the result would be misleading or harmful; or if the businesses of the parent and the subsidiary are so different that they cannot reasonably be treated as a single undertaking. On the last two scores, however, it is necessary to obtain the approval of the Board of Trade.

In general the particulars that must be given in consolidated accounts are the same as those laid down for the parent company itself. They are detailed in the Eighth Schedule of the 1948 Act. Balance-sheets must classify reserves, provisions, liabilities and fixed and current assets under headings appropriate to the company's business. Fixed assets must be distinguished from current assets, and the statement of the former must show their cost and the accumulated depreciation write-offs. This provides a valuable guide to the real worth of the assets, which can only be guessed at from a residual figure bereft of anything to show how it has been arrived at. The aggregate amounts respectively of capital reserves, revenue reserves and provisions must be stated separately, subject to the qualification that the Board of Trade may direct otherwise where it is satisfied that this is not required in the public interest and would prejudice the company. Where any of these items shows a change on the year an explanation must be given. Separate headings are also decreed for trade investments, other quoted investments (whose market value must be shown) and other unquoted investments.

Thousands of investors are now seeing the financial position more clearly because of the injunctions that in the balance-sheet the amount of bank loans and overdrafts shall be revealed and the net amount (after tax) of dividend appropriations shall be stated. In addition, a host of other details must be given. Particulars of any options outstanding, including the periods and prices; of the amount of Preference dividend arrears; of any charges on assets, contingent liabilities and contracts for capital

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expenditure; of the method of computing the tax provision—all these give a more rounded picture. So does the obligation laid upon directors to state the position where any of the current assets has not a value, on realization in the ordinary course of business, at least equal to the amount at which it is included in the balance-sheet. Another useful innovation is the compulsory presentation of comparative figures for the previous period.

That particular improvement has also to be incorporated in the profit and loss account. This must show separate debits for depreciation, Debenture and other interest, taxation (with distinction drawn “where practicable”, between income tax and other taxation), share or loan redemption provisions, additions to or withdrawals from reserves, investment income (with that from trade investments differentiated from that from other investments) and dividends paid or proposed. The company must also show the basis on which it has computed the annual charge for income tax—this is one of the profit and loss provisions paralleling the balance-sheet requirements—and state whether the figure shown for dividend appropriations is determined before income tax or after that charge. And tying up all the loose ends is the stipulation that the directors must reveal any material respects in which any profit and loss item is affected by transactions of a sort not usually undertaken by the company, or otherwise by circumstances of an exceptional nature, or by any change in the basis of accounting.

Apart from the Eighth Schedule, the provisions regarding accounts, directors’ report and audit are contained in Sections 147 to 163 of the 1948 Act and in Sections 196 and 197. Section 149 lays it down without equivocation that every balance-sheet and profit and loss account shall give a “true and fair view”. This injunction is reinforced in the Ninth Schedule, which requires the auditors to state expressly whether such a view is given, whether they have received all the information and explanations necessary for the purposes of their audit, and whether proper books of account have been kept. New-style auditors’ reports are certainly an immense improvement upon the reports couched in the old form—which, when parsed and analysed, meant just nothing. The auditors are made the sole judges of what information or explanation is necessary for the performance of their duties, and they become entitled to attend any general meeting of the company and to be heard at such a meeting on any part of the business which concerns them. Except for private companies (other than private companies

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which are subsidiaries of public companies) an auditor must, subject to certain exceptions, be a member of a body of accountants recognized by the Board of Trade. Special notice is required for a resolution appointing as auditor a person other than a retiring auditor or providing expressly that a retiring auditor shall not be reappointed. At the auditor's request the company must send a copy of his representations to shareholders, unless the Court is satisfied that the rights thus conferred are being abused to secure "needless publicity for defamatory matter". These provisions make it a lot harder for directors to "sack" an auditor whose views on his responsibilities and duties do not coincide with theirs.

Section 196 contains stringent requirements for the publication in the accounts of directors' emoluments. Since it came into force it has already brought to light isolated instances where directors' emoluments are surprisingly large in relation to dividends. This may be due to the fact that in old family businesses the directors and the equity shareholders are more or less the same people.

CHAPTER XX

PRIVATE COMPANIES UNDER THE NEW ACT

Some advantages in private registration—Restrictions on share transfers—Position of minority shareholders—Effect of 1948 Act—Some private companies exempt—Important new requirements—Advances in protecting shareholders.

ACCORDING to the company registration statistics of Jordan & Sons Ltd. (compiled by Mr. J. G. Hassell, F.C.I.S.) there were approximately 200,000 private companies on the register at 31st December, 1946, having an average issued capital of a little less than £10,000 as compared with 17,000-odd public companies having an average capital exceeding £300,000. By the end of 1947 (according to Board of Trade figures published in mid-1949) private companies amounted to 225,032 and public companies to 17,978. Although in these pages we are primarily interested in the few and the great, it is clear that the rights and obligations peculiar to private companies are worthy of consideration in the interests of those who hold shares in such undertakings.

Technically, a private company is one which, by its articles, restricts the right to transfer its shares, prohibits any invitation to the public to subscribe for shares or Debentures, and limits the number of members to fifty, excluding employees and ex-employees. It follows that all that is required for conversion into a public company is a special resolution altering the articles so as to remove those restrictions, although a number of formalities must afterwards be observed. When it is realized that a private company need not await a certificate from the Registrar of Companies before commencing business, allotting shares or borrowing money, and is not required to file a declaration of directors intimating their consent to act, or to hold a statutory meeting, it is not surprising that many companies intended for flotation are registered as private companies, only to be converted within a few days. The form which the restriction on transfer takes is subject to considerable variation in practice. In some cases a member desiring to transfer his shares is required to give notice to the directors, specifying the number of shares and the

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price asked. Only if the directors or their nominees are unwilling to buy at that price is the member free to find his own purchaser at that price. Alternatively, the transfer may be at a fixed price or at the auditor's valuation. Articles may expressly authorize the registration of transfers in favour of relatives of an existing member, but others may require that such shares, even when passing on a death, be offered to directors whether or not there is a desire to retain them.

When one considers the rights of a member of a private company, one naturally thinks of a minority holder. The member in control need not pause to consider his rights—one hopes that his emphasis is on obligations. The rights of a member of a private company in relation to general meetings arise from the articles. For instance, he may hold Preference shares which do not carry voting rights in that particular case, but an individual member cannot be debarred from receiving notices if the shares are of a class which are eligible. Even if he is not entitled to attend general meetings, he may inspect the minutes. Although he is not allowed to take extracts, the company is obliged to supply copies on payment being tendered at a rate not exceeding 6d. per 100 words. He is not entitled to inspect books of account.

Under the 1929 Act the company was not bound to circulate the balance-sheet and directors' report to members of a private company; but had to supply a copy, including the report of the auditors, on the same terms, on being requested to do so by any member, including a Preference shareholder. A Debenture holder had no similar right. There was no right to receive a copy of the profit and loss account, but this had to be laid before the company in general meeting.

These rights, it is clear, did not go very far, and the lot of the minority holder is somewhat like that of W. S. Gilbert's policeman. He must, of course, receive his share of the dividend, but he has no guarantee that available profits will be used in that way. Controlling directors may be quite happy to receive no dividend, if all the profits are being used to pay remuneration to themselves.

All this is bound up with the valuation of shares for death duty purposes. Special formulæ apply where the deceased held a controlling interest, but otherwise the shares must be valued at the amount which they would fetch on the open market at the date of death. There is, in point of fact, no open market, but it has been established that it must be assumed. The price must be that which a willing buyer would pay on the terms that he is

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registered as the owner of the shares, subject to the same disabilities and restrictions on transfer. Thus the value of a minority share is not proportionate to the price which a buyer might be prepared to pay for control, and the discount for unmarketability should be substantial. But the Estate Duty Office does not take kindly to such sentiments.

Turning to the company, as distinct from its members, there was no need to include a copy of the balance-sheet with the annual return of members and directors which all companies are required to file; the minimum number of members was two (compared with seven in the case of a public company); and a partner or a director or secretary may act as auditor. Whilst the latter may appear wrong in principle, it often works well in practice, as it is difficult to separate services which are rendered as director from those rendered in a professional capacity. That, in brief, was the position under the Companies Act of 1929, and the 1948 Act maintains the minimum number of members at two for a private company; but it makes some big changes in other respects.

The Law's New Requirements

IN considering the new provisions under the 1948 Companies Act (which consolidates the statutes of 1929 and 1947), it should be noted that the principle adopted by the Cohen Committee on Company Law, that the fullest practicable information should be made available for shareholders and the public, was in direct contrast with the traditional regard for the privacy of private companies. It was recognized, however, that not all of the latter represented family businesses—many were, in fact, subsidiaries of large public concerns. Whilst consolidated group accounts would ensure some degree of disclosure there was a case for requiring each member of a group headed by a public company to file its balance-sheet with the annual return. From this misalliance of conflicting interests a new class of company has been born, the exempt private company. So we now have public companies; private companies with special privileges; and other private companies. In general, it is a condition of exemption that no other company must hold shares or Debentures in the company, and that no person other than the member may be interested in the holding. Shares held by the following may, however, be disregarded:—

- (a) Personal representatives of a deceased member pending

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administration, or on behalf of a person afflicted by any form of disability.

- (b) Trustees under a will or family settlement in which no company is interested other than a charity or company acting only as trustee; or in connection with the administration of an insolvent estate.
- (c) Trustees for the benefit of employees and salaried directors.
- (d) Banks or finance companies as security, or by way of provision of additional capital, unless over 20 per cent of voting rights are held.
- (e) A company which is itself an exempt private company, unless shareholders of the group as a whole exceed fifty, excluding employees and ex-employees.

Finally, the number of Debenture holders must not exceed fifty; a company must not act as director; and the management must not be answerable to an unseen hand.

If it is established that a company is within this definition, the privileges enjoyed are:—

- (1) The balance-sheet will still not be filed.
- (2) The auditor need not be qualified.
- (3) Loans to directors continue to be unrestricted. (The privilege here is apparently that of the director.)

A private company which is not entitled to exemption must, on the other hand, observe the provisions indicated as if it were a public concern. All private companies will, however, be affected by other changes, which may be summarized as follows:—

- (a) The balance-sheet must be circulated to all members and Debenture holders without charge. As the profit and loss account is now to be annexed to the balance-sheet it must also be circulated as one of the documents required by law to be annexed thereto.
- (b) A director may be removed by ordinary resolution unless he was appointed for life before 18th July, 1945.
- (c) A member may present a winding-up petition when the articles necessary to maintain private company status are not being fulfilled, on the ground that the number of members has fallen below two.
- (d) A member may petition the Court if he complains that the affairs are being conducted to the detriment of some of the members. If satisfied the Court may, instead of ordering a winding-up, impose such a settlement on the parties as it thinks fit, including provision for conduct of future affairs,

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or purchase of shares by other members or by the company. In the latter case, the transaction will be treated as a reduction of capital.

Material advances have, it is clear, been made in protecting the interests of members of private companies. Apart from the specific points which have been mentioned, the more general provisions of the Companies Act, 1948 (of which several are discussed elsewhere, particularly in Chapter XXI) will be equally beneficial. These include developments in relation to design of accounts, appointment and re-election of directors and auditors, and lengthening of time limits generally. (A seven days' notice of meeting was not designed for a 1949 postal service.) In spite of all, however, one is still inclined to tender the same advice to prospective investors in private companies as that which Mr. Punch gave to those about to marry—Don't, except where there is control or active personal participation in the business.

CHAPTER XXI

THE PROTECTION OF SHAREHOLDERS

Small investors and the new Act—Longer notice of meetings—Preventing directors' rush tactics—Protection of minorities—Board of Trade investigations—New and sweeping powers.

IN the broad sense there is scarcely anything in the new Companies Act that does not have a bearing on the protection of shareholders—the provisions regarding prospectuses, accounts, auditors' responsibilities and the financial relations between companies and directors are all of first importance in this respect. In a narrower sense, however, we think of shareholders' protection as relating more to the efficacy of the control which shareholders can exercise over a company's affairs by using their votes at annual or other meetings, and to the legal processes which they can bring into play if they consider themselves aggrieved. The Cohen Committee's recommendations on shareholders' control were avowedly influenced by the great and growing tendency for the number of shareholders to increase, a tendency marked by a corresponding diminution in the size of the average shareholding. The translation of these recommendations into the Companies Act, 1948, is, in fact, primarily of significance for the small investor.

Consolidation of the 1929 Companies Act with the new 1947 Act was effected by the enactment of the Companies Act, 1948, all the provisions of which came into force on 1 July, 1948. But meanwhile the Board of Trade had promptly made an Order bringing into effect, as from 1 December, 1947, a number of the new provisions. These included, *inter alia*, the section which extends the time allowed for applying to the Court to cancel a variation of the rights attaching to any particular class of shares from seven to twenty-one days after the agreement of the majority is given. This is a reminder that the Cohen Committee set great store on devising "provisions which will make it difficult for directors to secure the hurried passage of controversial measures, and as far as possible to encourage shareholders carefully to consider any proposals required by law to be put before them by the directors".

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Under these provisions a company has to give shareholders twenty-one days' notice of annual general meeting. Allowing for the lodgement of proxies forty-eight hours before the meeting the previous requirement, of seven days' notice only, left but four days in which to organize opposition. Already twenty-one days' notice had to be given of meetings at which special resolutions (providing for a reduction in share capital, for example) are to be submitted. Only fourteen days' notice (instead of seven) is needed for meetings other than those in the two categories so described, since by their nature these are likely to be summoned in greater haste for urgent business. The balance-sheet must also be circulated twenty-one days (instead of seven days) before the annual meeting, and fourteen days' notice (instead of seven days) must be given of a proposal to appoint other auditors in place of a company's first auditors.

Besides preventing rush tactics on the part of the directors the Act also deprives the directors of their monopoly of the company's mechanism to push proposals through. A company is obliged on requisition by members holding not less than one-twentieth of the voting rights, or by not less than one hundred members holding shares on which an average of not less than £100 has been paid up per member, to circulate notice of any resolution these intend to move at the annual general meeting. It must also circulate an opposition statement of up to one thousand words in support of the resolution or bearing on the business of the meeting. The requisitionists have to bear the cost, unless the company resolves otherwise; they have to make their intention known to the company well in advance of the meeting; and the company can avoid its general duty if, "on the application either of the company or any other person who claims to be aggrieved, the Court is satisfied that the rights conferred by this section are being abused to secure needless publicity for defamatory matter". This proviso is worded so emphatically that it is difficult to believe that the Court will set aside the requisitionists' privileges without very good reason being shown.

Opposition at a Meeting

HAVING been given the time to organize and the right to use the company's own administration to make contact with fellow shareholders, the opposition now also finds itself in a better tactical position on the floor of the meeting. The right to demand a poll—that is, a card vote paying regard to the amount of the

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share holding, as opposed to a show of hands—has been made easier and more effective. A shareholder may appoint any other person, whether a shareholder or not, as his proxy to attend the meeting and vote on a poll, and, in the case of a private company, to speak on his behalf. Incidentally, “reasonable prominence” must be given in the notice of meeting to a statement making the proxy position plain, and the ambiguity in the position of nominees is removed by the provision that a member need not, if he votes, use all his votes or cast all the votes he uses one way.

Outside the meeting hall, a shareholder complaining that the affairs of a company are being conducted in an oppressive manner may, by applying to the Court, find a remedy other than the brutal, and possibly injurious one, of winding up. Where the Court is of the opinion that the “oppression” has been made out and that to wind up the company would unfairly prejudice the injured shareholders, it may make an Order regulating the conduct of the company’s affairs in future, or providing “for the purchase of the shares of any members of the company by other members of the company or by the company, and, in the case of a purchase by the company, for the reduction accordingly of the company’s capital”, or dealing with the position otherwise. Finally, while there is an extension of the power given to a company to acquire the shares of a dissenting minority in another company where a scheme or contract has been approved by the majority, the minority are protected by being given the right to require the first company to take over their holdings on the original terms, or on terms to be agreed, or on terms fixed by the Court. This removes the existing anomaly that while a company can force the dissentient minority to sell their shares, the minority, having fought a losing fight against acquisition and finding themselves in the position of a tiny batch of outsiders in a subsidiary, have no power to force the company to acquire the shares held by them.

More Effective Board of Trade Investigations

WHAT shareholders cannot do for themselves in the way of protecting their interests, the Board of Trade is now able to do for them with much greater facility than in the past. As from 1 December, 1947, those sections of the new legislation extending the Board of Trade’s powers to investigate the affairs of companies came into force. Between the wars there were a number

PRACTICAL INVESTMENT

of Board of Trade inquiries, and in some of these unparalleled ingenuity was shown in taking advantage of legal loopholes. An inquiry could be delayed for months, for instance, by alleging that the complainants were actuated by malice. It could be rendered difficult by refusing to allow the inspector the benefit of clerical assistance when he was inspecting a company's books, and in the end could be made nugatory by refusing to reveal anything about the affairs of subsidiary or associated companies. The new Act empowers the Board to appoint an inspector on the application of not less than two hundred members, even though these members do not satisfy the old requirement of holding, as a minimum, one-tenth of the shares issued. The applicants now have only to show "good reason" for requiring the investigation; it no longer has to be demonstrated that they are not actuated by malicious motives. The Board must appoint an inspector if the company itself by special resolution or the Court by Order declares that the affairs of the company ought to be investigated. But over and above all this the Board may appoint an inspector on its own volition if there are circumstances suggesting fraud or oppression or if the shareholders "have not been given all the information with respect to its affairs which they might reasonably expect".

This is a very sweeping power. Combined with Section 12 of the Prevention of Fraud (Investments) Act of 1939, which makes it an offence merely to mislead by making a "reckless" statement, promise or forecast, and combined with provisions ensuring that, if the company under investigation is a member of a group of companies, the inspector's powers shall extend to the whole group so far as he thinks it necessary for the purposes of his investigation, the path of the wrongdoer is now much more difficult. In fact, provided the Board of Trade continues to apply its newly acquired powers with the decision already demonstrated by one or two examples soon after the new Act became effective, this new legislation will best prove its value in a scarcity, rather than a multitude, of investigations. It will be clear that the standard of company behaviour, already high, has been raised still further by the tightening up of the law relating to companies. It is in the ready observance of a high standard of behaviour, with legal sanctions resting in the background instead of being used as a constant whip, that the real protection for the small investor ultimately resides.

At the same time, investors who are regular readers of the financial Press will have realized that if the editors and con-

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tributors to such organs know their business, and are determined to play their parts as watchdogs, a substantial measure of protection for the investor is also provided from this quarter. It is fair to say that a good deal of the credit for two important pieces of legislation in this sphere enacted during the past ten years or so belongs to the financial newspapers. By scathing criticisms of fraudulent companies and outside brokers certain organs of the financial Press helped to show the need for the Prevention of Fraud (Investments) Act. And constant Press criticisms of deficiencies in company reports and accounts, more particularly where an important company had failed to present consolidated accounts, brought to light many questions which have found their answers in the Companies Act 1948.

If a new Debenture issue appears to have but rickety security (it might happen, even now), or if directors of a company extend that company's interests injudiciously, say by purchase of fresh assets from someone already closely connected with the undertaking—one can generally rely on the matters receiving attention from the financial journalists. Above all, these gentlemen really enjoy themselves when analysing some complicated capital reconstruction scheme which professes to deal out even-handed justice to all classes of shareholders concerned, but which is often found to fail lamentably in this respect. Generally, it is the Preference shareholders who suffer under such schemes.

Publicity given in the Press to deficiencies of this kind has frequently caused the framers of such schemes to think again. And in many respects the new Act will help financial journalists in this aspect of their work.

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